NXP Semiconductors N.V., Q2 2022 Earnings Call, Jul 26, 2022 (EditedCopy)

TEXT version of Transcript

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* William J. Betz

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Presentation

Operator [1]

Good morning, ladies and gentlemen. Thank you for standing by, and welcome to the NXP Second Quarter 2022 Earnings Conference Call. [Operator Instructions] Please be advised that today's conference may be recorded.

I would now like to hand the conference over to your speaker host today, Jeff Palmer. Please go ahead, sir.

Jeff Palmer, NXP Semiconductors N.V. - Vice President of Investor Relations [2]

Thank you, Olivia. Good morning, everyone. Welcome to NXP Semiconductor's Second Quarter 2002 (sic) [2022] Earnings Call. With me on the call today is Kurt Sievers, NXP's President and CEO; and Bill Betz, our CFO. The call today is being recorded and will be available for replay from our corporate website.

Today's call will include forward-looking statements that involve risks and uncertainties that could cause NXP's results to differ materially from management's current expectations. These risks and uncertainties include, but are not limited to, statements regarding the continued impact of the COVID-19 pandemic on our business, the macroeconomic impact on the specific end markets in which we operate, the sale of new and existing products and our expectations for the financial results for the third quarter of 2022. Please be reminded that NXP undertakes no obligation to revise or update publicly any forward-looking statements. For a full disclosure on forward-looking statements, please refer to our press release.

Additionally, we will refer to certain non-GAAP financial measures, which are driven by -- primarily by discrete events that management does not consider to be directly related to NXP's underlying core operating performance. Pursuant to Regulation G, NXP has provided reconciliations of the non-GAAP financial measures to the most directly comparable GAAP measures in our second quarter 2002 (sic) [2022] earnings press release, which will be furnished to the SEC on Form K and is available on NXP's website in the Investor Relations section at nxp.com.

Now I'd like to turn the call over to Kurt.

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [3]

Thank you very much, Jeff, and good morning, everyone. We appreciate you all joining our call today.

Let me begin with a review of our quarter 2 performance. Our revenue was $37 million better than the midpoint of our guidance, with Automotive and Industrial & IoT above our guidance, while trends in the Mobile and Communication Infrastructure markets were in line with our expectations. Taken together, NXP delivered quarter 2 revenue of $3.31 billion, an increase of 28% year-over-year.

Our non-GAAP operating margin in quarter 2 was a record 36%, 400 basis points better than the year ago period and about 30 basis points above the midpoint of our guidance. Our results reflect strong execution, with better-than-guided operating leverage and profit fall-through on the incrementally higher revenue on top of improved gross profit.

Now let me turn to the specific trends in our focus end markets. In Automotive, revenue was $1.71 billion, up 36% year-over-year, near the high end of guidance. In Industrial & IoT, revenue was $713 million, up 25% year-on-year, better than our guidance. In Mobile, revenue was $388 million, up 12% year-on-year, in line with our guidance. And lastly, Communication Infrastructure & Other revenue was $498 million, up 20% year-on-year, in line with our guidance.

Looking at the trends across our end markets, we are not naive to believe NXP is immune from the clearly weakening macro environment. We are highly alert, and we review frequently and very closely several key indicators relative to the dynamics of customer demand versus supply, inventory per channel per end market and per geography.

When we look at demand signals, we have a high level of confidence in the intermediate-term outlook. This is especially true in terms of demand trends in the Automotive and Industrial markets, which account for the majority of our total revenue. While there is a well-documented weakness in the low-end Android handset market, it is important to note that our Mobile business is more biased towards the premium-tier vendors. And in aggregate, our Mobile business accounts for only about 12% of our total revenue.

In terms of the PC and broad consumer electronics markets, there are much smaller contributors in the IoT portion of our Industrial & IoT segment.

In terms of customer behaviors, we do not see any substantial weakening within the Auto and Industrial customer base. Relative to long-term committed customer demand, a large percentage of our major customers continue to firmly desire supply assurance commitments, which are facilitated by placing noncancelable, nonreturnable orders with us throughout 2023. And currently, the level of NCNR orders into 2023 is greater than our ability to service.

In terms of key operating metrics, which inform our short-term decisions, demand continues to outpace our gradually and incrementally improving supply capability. Furthermore, even as we actively derisk our existing backlog for potential double or any stale orders, we judge supply to only address approximately 80% of the underlying demand. Additionally, we continue to redirect shipments to those customers which are at risk of going lines down, thus avoiding excess or stagnant inventory buildup.

When looking at customer inventory, we continue to see a dysfunctional supply chain, which struggles to get the right product mix and complete kits to the correct location in the extended Automotive and Industrial markets.

Now in terms of our own on-hand inventory, it has increased through quarter 2 on a dollar basis, consistent with orders placed to our suppliers and internal build plans. The primary area of increase is in raw material and work in progress in order to fulfill firm customer commitments in future and especially in quarter 3. On a days basis, DIO was 94, an increase of 5 days sequentially, and closer to our long-term target of 95 days.

Now moving to the distribution channel, which services about half of our total revenue. Inventory continues to remain stubbornly below our long-term targets. During quarter 2, the months of supply in the channel was barely 1.6, which is about a month below our long-term target, and it is now the seventh consecutive quarter of an exceedingly tight supply situation in the channel.

Finally, let me speak to our ability to service customer requirements. Lead times continue to be extended, with more than 80% of all products being quoted at 52 weeks or greater, which is actually on a similar level to last quarter.

So in summary, against this dynamic backdrop, our second quarter and the first half of the year was a good beginning to what we view will be a positive year for NXP. We do continue to see the second half of the year greater than the first on an absolute dollar basis.

Now let me turn to our expectations for quarter 3. We are guiding revenue at $3.425 billion, up about 20% versus the third quarter of 2021, within a range of up 17% to up 22% year-on-year. From a sequential perspective, this represents growth of about 3% at the midpoint versus the prior quarter.

At the midpoint, we anticipate the following trends in our business. Automotive is expected to be up in the low 20% range versus quarter 3 '21 and up in the mid-single-digit range versus quarter 2 '22. Industrial & IoT is expected to be up in the low 20% range year-on-year and up in the mid-single-digit range versus quarter 2 '22. Mobile is expected to be up about 10% year-on-year and down in the low single-digit range versus quarter 2 '22. And finally, Communication Infrastructure & Other is expected to be up in the low double-digit range versus the same period a year ago and up in the low single-digit range on a sequential basis.

Let me summarize. The growth we have anticipated for 2022 is materializing, notwithstanding the clear macro crosscurrents and the continued supply challenges. We do continue to see strong customer demand in the Automotive and Industrial segments as well as within our company-specific accelerated growth drivers. Overall, demand continues to outpace increasing supply. However, we are staying paranoid about the macro environment. And hence, we will continue to work very diligently and in a very disciplined manner to assure inventory across all end markets remains lean.

And with that, I would like to pass the bill over to you -- the call over to you, Bill, for a review of our financial performance. Bill?

William J. Betz, NXP Semiconductors N.V. - Executive VP & CFO [4]

Thank you, Kurt, and good morning to everyone on today's call. As Kurt has already covered the drivers of the revenue during Q2 and provided our revenue outlook for Q3, I will move to the financial highlights.

Overall, our Q2 financial performance was very good. Revenue was $37 million above the midpoint of our guidance range. And both non-GAAP gross profit and non-GAAP operating profit were above the midpoint of our guidance.

Now moving to the details of Q2. Total revenue was $3.31 billion, up 28% year-on-year and above the midpoint of our guidance range. We generated $1.92 billion in non-GAAP gross profit and reported a non-GAAP gross margin of 57.8%, which is up 170 basis points year-on-year and both above the midpoint of the guidance range as a result of higher revenue and positive product mix.

Total non-GAAP operating expenses were $724 million or 21.9%, up $98 million year-on-year and up $36 million from Q1, in line with our guidance range but the lower long-term model. From a total operating profit perspective, non-GAAP operating profit was $1.19 billion, and non-GAAP operating margin was 36%, up 400 basis points year-on-year and both above the midpoint of the guidance range. Non-GAAP interest expense was $97 million, with cash taxes for ongoing operations of $150 million or approximately 13.7% effective cash tax rate, and noncontrolling interest was $13 million. Stock-based compensation, which is not included in our non-GAAP earnings, was $89 million.

Now I would like to turn to the changes in our cash and debt. Our total debt at the end of Q1 was $11.16 billion, up $587 million sequentially as we issued $1.5 billion of new debt and simultaneously retired early the $900 million of debt, which was due in June of 2023. Our ending cash position was $3.55 billion, up $862 million sequentially due to a combination of the previously mentioned financing, CapEx investments and capital returns during Q2. The resulting net debt was $7.62 billion, and we exited the quarter with a trailing 12-month adjusted EBITDA of $4.96 billion. Our ratio of net debt to trailing 12-month adjusted EBITDA at the end of Q2 was 1.5x, and our 12-month adjusted EBITDA interest coverage was 12.7x.

Turning to working capital metrics, days of inventory was 94 days, an increase of 5 days sequentially, and close to our long-term DIO target of 95 days as we continue to experience incrementally improved supply trends. The increase in on-hand inventory was primarily in raw materials and work in process to support revenue growth in subsequent periods especially Q3. We continue to closely manage our distribution channel, with inventory in the channel at 1.6 months, well below our long-term target. Days receivable were 27 days, flat sequentially. And days payable were 94, an increase of 1 day versus the prior quarter.

Taken together, our cash conversion cycle was 27 days, reflecting strong customer demand, solid receivable collections and positioning for customer deliveries for future periods. Our working capital management and balance sheet metrics continue to be very strong.

Cash flow from operations was $819 million, and net CapEx was $268 million or 8.1% of revenue, resulting in non-GAAP free cash flow of $551 million or 17% of revenue. During Q2, we paid $222 million in cash dividends. On a trailing 12-month basis, we have returned 132% of our non-GAAP free cash flow back to the owners of the company, consistent with our capital allocation strategy. The cash flow generation of the business continues to be excellent.

Turning now to our expectations for Q3. As Kurt mentioned, we anticipate revenue to be about $3.425 billion, plus or minus about $75 million at the midpoint. This is up 20% year-on-year and about 3% sequentially. We expect non-GAAP gross margin to be about 57.8%, plus or minus 50 basis points.

Operating expenses are expected to be about $743 million, plus or minus about $10 million, which is up about 3% sequentially, driven by hiring, especially new college graduates and our normal project spend. Taken together, we see non-GAAP operating margin to be 36.1% at the midpoint. We estimate non-GAAP financial expense to be about $95 million and anticipate cash tax related to ongoing operations to be about $160 million or about a 14% effective cash tax rate, consistent with our communicated model.

Noncontrolling interest should be about $13 million. For Q3, we suggest that, for modeling purposes, you use an average share count of 265 million shares.

Finally, I have a few closing comments I'd like to make. First, as Kurt mentioned in his prepared remarks, we have attempted to derisk our Q3 outlook given the combination of the uncertain macroeconomic environment, and we'll document the weakness in the Mobile and consumer end markets. Despite these potential risks, customer demand in the Automotive and Industrial remains strong and greater than our immediate ability to supply.

Secondly, from a unique revenue growth standpoint, since November of last year at Investor Day, we discussed 6 accelerated growth drivers. Looking at our first half performance of 2022 versus the same period last year, we are very well on track to the targets we presented.

Lastly, our people. We are very proud of all our team members globally and especially those in China, who continue to overcome severe COVID restrictions while simultaneously dealing with global supply chain disruptions this past quarter. We continue to be amazed at our employees' incredible dedication and resilience and for powering through these extremely tough times. Our results are a testament to their hard work.

With that, thank you, and I'll now turn it back over to the operator for questions.

Question And Answer

Operator [1]

[Operator Instructions] And our first question coming from the line of William Stein from Truist.

William Stein, Truist Securities, Inc., Research Division - Managing Director [2]

Congratulations on the strong execution. My first question relates to your reference to risk-adjusted backlog. Bill, you've done a -- both Bill and Kurt have done a bit of explaining that in the prepared remarks. But I'm wondering if you can comment on your nominal backlog. And it sounds like the reasoning is related to more things you see outside of the company than what you see in your actual order trends. Maybe you can talk about the thought process and the magnitude of that risk adjustment.

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [3]

Yes. Thanks, Will. What I tried to convey is indeed, first and foremost, that for the foreseeable period ahead of us, we are actually only covered with 80% with our supply against the true demand which we see. And when I say true demand, then that comes back to the risk adjustment. For good reasons, we have never revealed the size of our backlog to the past quarters because I think I've always been clear that we've always believed, inside that huge backlog, there might be double orders which is just normal human behavior in times of shortage.

Now over the past quarters, we have clearly learned much more from a transparency perspective about the true minimum needs of our end customers across all markets. And we have very rigidly applied that knowledge to try and actually risk-adjust that backlog in order to come to a number which is maybe more meaningful. And I just want to emphasize, after doing that, Will, we still have only that 80% coverage of our increasing supply capability against that risk-adjusted demand. So what we try to say is we try to be realistic around the size of the backlog that's why we risk-adjusted, and that is different in each of the markets we serve. The result of it leads in the foreseeable future to 80% coverage of that adjusted demand.

William Stein, Truist Securities, Inc., Research Division - Managing Director [4]

Great. That helps a lot. Maybe the follow-up to that feels pretty natural is, what is the company doing to improve [supply] with internal capacity, your current foundry partners? And is there any effort underway to extend foundry relationships that could allow you to sort of come closer to meeting your customer demand?

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [5]

Yes. Clearly, we absolutely stick to our hybrid manufacturing model. We continue to believe, and I think the results of the past 6 to 8 quarters have given good evidence of that, that this is -- for the portfolio, we are serving a very superior model of serving the needs of our customers. And what that means is that, indeed, we are working on both ends of the equation. About 60% of our current wafer supply is coming from foundry partners. And that is more and more predominantly tuned into CMOS logic processes, especially when it comes to 300-millimeter and when it is below 90 nanometers.

And in there, we are definitely ramping up significantly our partnerships and our strategic collaboration with key foundry partners. We've spoken about this in the past. And that is also what clearly is helping us in the past quarters. In the coming quarter, we talked about the sequential growth going forward in incrementally increasing our supply. At the very same time, we are remodeling our own factories, which are all 200-millimeter facilities, to be the prime place for manufacturing proprietary specialty processes, which are unique to NXP. And by moving out more of the CMOS to our foundry partners, we are creating more space internally in our existing facilities to serve the increased and ever-growing needs for these proprietary technologies going forward.

So that is a refinement of the hybrid model. But it's still important that I really want to emphasize we stick to the hybrid model, which again has also allowed us to outgrow our key peers in that market over the last 6 quarters.

Operator [6]

And our next question coming from the line of Ross Seymore with Deutsche Bank.

Ross Clark Seymore, Deutsche Bank AG, Research Division - Managing Director [7]

Kurt, I wanted to dive a little bit into the potential disconnect of you guys doing everything you can to manage the backlog, scrub it, appreciate what's going on in macro. But yet the guidance seems fine in the quarter, and you said you're going to grow in the second half versus the first.

So I guess, as you look at that, when do you think it will start to be a little bit more apparent what macro is doing if it stays like it is? And maybe more pointedly, it's great that you're growing in the second half, but last quarter, you said you thought you would grow sequentially in the third and fourth quarters. So does that growth in the second half imply that you still believe you will grow sequentially in the fourth quarter?

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [8]

Yes, so thanks, Ross. First of all, indeed, we try to make sure that you all hear loud and clear that we are not neglecting the crosscurrents in the macro, which have also started to be visible in our orders, especially in the Mobile market. Now Mobile is, for us, relatively small, so it doesn't really impact the whole company very much. But the principle we are applying is to be hyper disciplined and hyper paranoid to not grow any inventory down the chain. So we try to stay there as disciplined as we can be, and the first area where we are applying this as we speak is in our Mobile market and, to a certain extent, in the small portions of consumer -- more consumer-oriented segments inside our Industrial & IoT sector.

Now when you ask about the second half, yes, we are confirming within this more turmoiled macro that the second half is going to grow sequentially over the first half in absolute dollar terms. We just gave you the guidance for quarter 3. I don't have a crystal ball for quarter 4, but I can tell you that we remain totally sold out for the rest of the year. I also tried to highlight that supply continues to ramp up sequentially into the next quarters. So I cannot really make a firm assessment on what Mobile and other consumer markets will do into the fourth quarter. But clearly, from the strength in the Automotive and Industrial sectors which we are serving, we are quite optimistic for the second half to also continue to grow sequentially.

Ross Clark Seymore, Deutsche Bank AG, Research Division - Managing Director [9]

I guess my follow-up one for Bill. I noticed this is the first quarter in, I think, a couple of years that you guys didn't repurchase any shares. Lots of people trying to read into what that may or may not mean. But can you go into the thinking of what led you to stop the buyback for a quarter?

William J. Betz, NXP Semiconductors N.V. - Executive VP & CFO [10]

Yes, first off, thanks, Ross, for your question, and I wouldn't read too much into it. First off, there's no change to our capital return policy. As stated many, many times, we will return all excess free cash flow on a trailing 12-month basis. During Q2, in my prepared remarks, we returned 132% of our 12 -- trailing 12 months for free cash flow. Remember, we also raised our dividend in the quarter by 50%, and we still have authorization buyback of over $3 billion from our Board. At the end of the year, we do expect to return to be at least 100% or higher, consistent with our stated policy.

Operator [11]

And our next question coming from the line of C.J. Muse with Evercore ISI.

Christopher James Muse, Evercore ISI Institutional Equities, Research Division - Senior MD, Head of Global Semiconductor Research & Senior Equity Research Analyst [12]

I guess first question, Kurt, I was hoping you could speak to how you're thinking about the overall state of the auto industry. This morning [indiscernible], but it looks like your second half prior outlook was perhaps a bit aggressive. At the same time, you have OEMs that are waiting for those golden screws, and hopefully, we'll get those. But as I look at your mix, obviously, EV and ADAS, along with higher input costs and higher ASPs, are sustaining excellent growth for you guys.

So curious, how do you see things playing out? And what -- when do you think we can normalize in the auto supply demand side of things? Is that in 2023? Or might that be longer?

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [13]

Yes. Thanks, C.J. That's not an easy question. I dare to follow IHS in the first place, which I think hasn't changed the forecast for this year for the SAAR very much. I think the continue to speak about like a 5% growth of the SAAR this year, which would get us to, well, just short of 81 million cars this year. However, that includes a 9% half 2 over half 1 growth in car production this year, which is not a big surprise because I think half 1, again, has suffered massively from semiconductor shortages. And especially in the second quarter, it has suffered a lot from the COVID shutdowns in China, which impacted mainly the Japanese, Chinese and Southeast Asian car production. I mean there was little less pronounced for the Western world but a lot in China and Japan. And mind you that China continues to be the largest car country in the world.

So from a shorter-term perspective, C.J., I think half 2 car production will grow quite nicely over the first half finally, and that trend should also continue, according to IHS, into the next year, which I think will be another 8% growth or so. All of that, in our view, is still probably short of consumer demand. Now it will depend on the macro and blooming recessions in different geographies, to what extent consumer demand is muted for cars. But we think the car production is so low and so far below the highs in 2018 or early '19 that even if consumer demand is muting, there is still a gap such that, I think, it's very realistic to assume that car production continues to grow.

Now at the same time, and I know we have discussed it to death before, the bigger factor for us, however, certainly remains the content increase. And from a content increase, it's just amazing. Every quarter, I come with new numbers here, especially EV penetration has accelerated again. I think the latest forecast for this year is now that 26% of the global car production is going to be xEVs. I think last quarter, we talked about 23%. I mean these are massive numbers. And this 26% this year is in absolute terms of 46% year-on-year growth in xEV production. And again, mind you that with our battery management inverter control and many, many microprocessors and micro controllers associated with xEVs and an overall semi contact, which is more than 2x relative to combustion engine cars, this continues to be a massive momentum ahead of the car production, which in itself is now also growing.

So sorry for the lengthy reply, but we are quite animated about the fact that there continues to be a big gap there, and the content increase is pulling the card for us.

Christopher James Muse, Evercore ISI Institutional Equities, Research Division - Senior MD, Head of Global Semiconductor Research & Senior Equity Research Analyst [14]

That's very helpful. As my follow-up, I heard the earlier comments around absolutely adhering to your hybrid manufacturing model, but you did speak to optimizing your internal capacity and considering the 8-inch, 90-nanometer and above demand that's out there. Is there a point in time where you would need to consider a new JV factory with TSMC?

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [15]

Well, first half of your question, yes. Second half, I will not comment to because the matter of the fact is, yes, what I described will very naturally, with continuously growing demand, leads to a moment where our internal 4 walls' existing capacity, even after the reshuffling I described, will not be enough to serve future demand.

So yes, we will do something about it, but there is various different ways of achieving this, C.J. So it don't get locked down into the idea with TSM. There is all sorts of options which we can do, including but, again, not exclusively but also including the opportunities which are being provided by the chipset in Europe and the U.S., where the majority of our facilities are.

Operator [16]

And our next question coming from the line of Vivek Arya with Bank of America.

Vivek Arya, BofA Securities, Research Division - MD in Equity Research & Research Analyst [17]

Kurt, I wanted to ask about NCNR orders and pricing dynamics. Let's say, if auto production is flat or down next year, I'm curious, how enforceable are these NCNR orders? And how defensible will the pricing strength be in that kind of market?

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [18]

Yes, thanks, Vivek. Let me start with the second part, the pricing. Given the very stubborn imbalance between supply and demand in most of the technologies needed for automotive, I have a very high confidence that the pricing is very stable. I would actually -- and maybe unfortunately go a step further. We do continue to see our input cost rising also into next year, which would, indeed, force us to also continue to raise our pricing.

So rather than thinking about pricing to become softer again, I believe that especially in the automotive environment, where the supply-demand imbalance is [indiscernible] into next year, there is a chance that pricing continues to go up into next year. Again, and I think I said it a number of times, we have a very clear and very much transparent policy here that we are increasing our prices to the customers in line with the input cost increases which we are experiencing in order to protect our gross margin percentages.

So on that side, from a pricing perspective, even with the flat car production or maybe, as you said -- as you suggested, which I don't think is going to be the case, reducing car production, I think that would still be the case because of the content increases, which are driving so much demand, anyway.

Now the other side was the supply situation per se. In a way, I answered it. Given content increases surpassing the impact or outbalancing the impact of the SAAR so much, I unfortunately believe that even in a soft reduction of SAAR next year, we would continue to see, in many technologies, an imbalance between supply and demand next year.

Vivek Arya, BofA Securities, Research Division - MD in Equity Research & Research Analyst [19]

Right. Then my follow-up is on the margins. So gross margins are getting towards the high end of your target, and I think EBIT margin, from what I see, you're guiding a little bit above the high end of your target model. Is it time to revise the model? And let's say, if Q4 grows sequentially, can margins also continue to expand? Is there still a positive leverage in the model?

William J. Betz, NXP Semiconductors N.V. - Executive VP & CFO [20]

Vivek, this is Bill. I'll take that question. So related to the high end of our model, yes, we are performing at those levels at this current time. I'd just like to remind everyone that we'll focus on growing our top line, our revenue. And a faster growth at the top line of 1% will be greater and better than a 1% change in our margin as we go forward. We're not going to update our long-term model every quarter or every year, and we will revisit this during our normal 3-year long-term model that we provide or if there's any material change to our business model.

So no change. We feel very confident to run, like I mentioned last call, in the -- toward the high end of the model for the rest of the year.

Operator [21]

And our next question is coming from the line of Gary Mobley with Wells Fargo.

Gary Wade Mobley, Wells Fargo Securities, LLC, Research Division - Senior Analyst [22]

I appreciate your commentary with respect to how you derisked in your third quarter guide, the different macro issues and whatnot. But want to ask conversely, what can go right in the last 2-plus months of the quarter to maybe hit the high end of the expectation as it relates to COVID mitigation in China, kitting issues, additional supply and whatnot?

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [23]

Gary, I mean, we give a guidance with the midpoint in the range in order to comprehend risks and opportunities at the same time. I think the elements you just listed are certainly part of, well, both potential risk and potential opportunities. Again, we carefully thought about weighing the upsides and downsides, and that's why we landed on a -- on the midpoint of $3.425 billion as we just guided a couple of minutes ago.

I would say the following: for us, the overall sentiment is given the big percentage in our revenue is obviously dominated by how Automotive and Industrial markets are going. And here, a guidance for the next quarter is really driven by what we hear from our customers. I mean it's such a short period of time in a way that it is really just tuned into the short-term customer-confirmed orders and our supply capability. And the way I would put it, Q3 upsides are probably more than anything dominated by our supply capabilities since we are sold out for the quarter.

Gary Wade Mobley, Wells Fargo Securities, LLC, Research Division - Senior Analyst [24]

Appreciate the color, Kurt. As my follow-up, I wanted to ask about the 6 accelerated growth drivers that you begin to outline at your Analyst Day and continue to outline. Of the 6 and looking out over the next 12 months, which of those 6 would you expect to be the biggest contributor to your revenue growth?

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [25]

Well, the 6 accelerated growth drivers, I mean, we guided them for 3 years. When we did our Investor Day in November of last year, that was really meant as a 3-year guidance. And you've also seen the relative sizes between them and the relative growth speed. And I think Bill, in his prepared remarks, emphasized that we are, what did you say, very well on track, Bill, for all 6 of them. So I think the way you should look at this is that all 6 are very much intact and the relative contribution of them is in line with how we guided them at the Investor Day last November. There is no change. But what I think is important to say is that they are all on a very good track.

Operator [26]

And our next question coming from the line of Joseph Moore or with Morgan Stanley.

Joseph Lawrence Moore, Morgan Stanley, Research Division - Executive Director [27]

In your answer to your prior question, you said you were going to be careful with sort of customers trying to build inventory, but there's also a clear message from your Automotive customers that they do want to hold a larger amount of safety stock. Can you talk to that effort generally? Do you see that build having started yet?

Where -- do you plan to allow them to have to hold more safety buffer? And do you expect that to happen at the OEM level or at the Tier 1 level if that does happen?

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [28]

Yes, Stacy (sic) [Joseph]. that is an important dynamic indeed. So in general, I'd say the OEMs try to leave that challenge with the Tier 1s. There might be exceptions here and there, but the more general direction is that the OEMs put this on the shoulders of the Tier 1s. Size of that is varying. We see and hear about requests, which are in the order of 3 months. We hear others which talk about 6 months of inventory. It is also not the same for each product. They categorize, I think, more into very single-source, very strategic products versus more commodity-like products. So it has all sorts of variations, but I think, first of all, general message, more with the Tier 1s than the OEMs.

Has it started yet? No. The supply capability, at least relative to NXP product, I mean I can't make that comment for my peers. But for our product, no, it hasn't started yet.

Any inventory build, which accidentally might happen at Tier 1 at the moment is indeed more related to the golden screw problem, where it builds for a while and then it flushes through again when the golden screw product becomes available. But that's not associated with or because of the intended safety stocks. I believe that somewhere in the course of next year, that will, in a more methodical way, start to be built. I do, indeed, believe that towards 6 months might be a consensus many of them want to achieve. But again, only in the course of next year.

Operator [29]

And our next question coming from the line of Stacy Rasgon with Bernstein.

Stacy Aaron Rasgon, Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst [30]

The first one, Bill, I wanted to follow up on a comment that you might have made in passing. I know you guys had talked about derisking Q3 backlog, but Bill, you actually said that you derisked Q3 outlook. I'm actually wondering, did you actually reduce the revenue outlook that you gave, coincident with some of the cautions that you talked about? I'm not sure you did because it also sounds like you're supply-constrained anyways. But was there any sort of reduction at all in your outlook given the macro issues that you're seeing? And if so, like how much was it and which end markets?

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [31]

Yes, so probably that is a matter of fact for especially the Mobile market, where you saw that we actually guided sequentially a touchdown. Since we are not overly, but we are also exposed to the low-end Android players in China, and I have a total paranoia to not build any inventory there. So I'd say there is probably indeed a risk adjustment on -- from the macro perspective relative to Mobile in that particular part of our business. There, at the same time, in Auto and Industrial for the third quarter, I can only repeat what I said earlier. We are sold out, and the revenue capability is much more determined by our supply capability in the third quarter. So it's a mixed picture where the majority is clearly -- continues to be supply-constrained.

The risk adjustment -- let me take one more. The risk adjustment was also a longer-term message, which is really related to the assessment of about 80% supply coverage against demand. That is not just a statement for Q3. I mean that is really a statement for the longer-term period. I would go that far to say it includes very large parts of next year actually, where that judgment is done after risk adjustments. And risk adjustments are also when we get all the patterns, say, in Automotive -- from Automotive customers, and we add them all up, and then we know what content increases should be. We know where the car production could possibly be next year. And then, of course, you see that all the different Tier 1s want to win market share. All the OEMs want to win market share against each other. And the sum of the parts is the bigger of what could be realistic.

So then we make a risk adjustment to this because we know that the SAAR can only be at a certain size next year. So that's one of the elements which I would label, practically speaking, risk adjustments, where we bring down what looks like an overwhelmingly huge backlog.

Stacy Aaron Rasgon, Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst [32]

Got it. That's super helpful. For my follow-up, I wanted to repeat a question. Somebody else asked it, but I don't think you actually answered it. It was around the noncancelable, nonreturnable orders. We've seen these from other companies, and it turns out, in practice, maybe they're not quite as noncancelable as they appeared. How noncancelable or nonreturnable are your NCNR orders really?

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [33]

Well, indeed, sorry, I know that was part of an earlier question. I think I missed speaking to it. Well, it's like with every contract. There is clearly a legal system in place. But in the end, of course, reasonable behavior will prevail. What I can tell you, however, is that so far, every one of them has been fulfilled. I mean there is no -- we don't see any -- in Automotive and Industrial, there is no pushouts. There is no cancellations. People want to have more product. Now how that looks at some time in the future, when maybe macro continues to change more, could be different. But fundamentally, we put that system in place in order to make sure that our customers are serious and think 2 times and 3 times about what level of orders they want to put on us.

And mind you that in many markets, different products from different customers go into one end product. So we have to make sure that there is a proper allocation between them. Then otherwise, the car company is only suffering in the end. I mean if there is too much orders from one Tier 1 and the other one orders not enough, then it doesn't help the car company. That's another reason why we are really trying to put NCNRs in place in order to hold people to the truth.

William J. Betz, NXP Semiconductors N.V. - Executive VP & CFO [34]

Let me just add to what Kurt mentioned. What we said this year, our NCNRs were larger than our long-term commitments. Of those NCNRs, we can't service them all. We have started our process for 2023 NCNRs, and they're tracking to similar levels as well, which we won't be able to supply as we go forward.

Operator [35]

Our next question coming from the line of Matt Ramsay with Cowen.

Matthew D. Ramsay, Cowen and Company, LLC, Research Division - MD & Senior Technology Analyst [36]

Bill, I wanted to ask a question about OpEx in sort of the context of the macro environment that we're talking about here. You guys have -- with the revenue growth and the gross margin expansion, I think growing gross profit, I don't know, it will be 75% or something like that from '20 to '22, and that's allowed for a lot of expansion of the operating expense while you're still getting leverage. And I guess the question is with inflationary pressures and wages and all those things, it seems like there's still some upward pressure in the OpEx line.

And I just wanted to know what kind of levers you had to control that and what the priorities would be to control that if, in fact, the macro did turn. And would you be committed to sort of holding the operating margin flat? Or is there a case where you're going to need to keep spending despite what might go on in the macro? I guess just puts and takes on OpEx would be helpful.

William J. Betz, NXP Semiconductors N.V. - Executive VP & CFO [37]

Sure. Thank you for your question. Again, we continue to do very well here as we are operating below the 23% long-term model. Q2, we finished at 21.9%, and that was slightly better than our guide. And I think we just guided 21.7%. And again, that primary increase from an absolute standpoint is really being driven by our new college graduates joining the company and continuing R&D investments supporting our growth ambitions.

Now if there is a downturn, what will we do? We have a plan for that. It's well defined. It's all around protecting our free cash flow. Our plan actions would potentially include reducing variable compensation, reduced discretionary spending, reducing noncritical CapEx. We'll slow down our nonengineering hiring.

And also, right, our attrition runs around 10%, 12%. We would obviously not backfill all of those, depending how severe it gets.

By all means, we will protect our R&D engine of the company, which, I've said in the past as well as Kurt, is the lifeblood of our growth. And then similar with optimizing our costs, you have to remember, the last 2 years, we've been optimizing towards material shipments to prevent customer line downs. We haven't been focused on our mix or optimizing of costs or yields or cycle time. So that's another level that -- a lever that we have in our playbook to maintain our margins in our range that we shared during our Analyst Day.

Matthew D. Ramsay, Cowen and Company, LLC, Research Division - MD & Senior Technology Analyst [38]

Got it. A quick follow-up for Kurt. I was interested in your prepared script. I think you mentioned that the same sort of ratio of your product portfolio still had 52-week lead times as it was last quarter. We get a lot of investor questions about maybe there's shortages of part X, but there's inventory builds of part Y and part Z, and things are out of balance. It doesn't seem like that's the case with NXP's business. I'd be interested if you could comment on that a bit further.

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [39]

Yes, absolutely, Matt. I guess that really has to do with the mix of our end market exposure. So I would actually confirm that in Mobile, we are probably moving away from supply constraints. But those technologies are badly needed in other markets which we are serving, which are heavily underserved, while the demand there continues to go up. So it is, of course, a puzzle where we quickly try to redirect from where demand is softening. And again, that's especially the low-end Android handsets and some of the more consumer-oriented products in China, which is little for us.

I mean the whole point is this is not that much for us, but that little where we have it, we move it to other areas in Auto and Industrial, where actually demand continues to go up, such that in the bottom line in the end, we unfortunately -- and I really have to put it that way, we are still at a similar lead time pattern as we had indeed last quarter, which is that about 80% of the portfolio sits at 52 weeks plus a lead time. But it is different product.

So that's why I totally understand and support your question. It is not exactly on the same products because it's moving. But in the mix, it still stays at that level.

Jeff Palmer, NXP Semiconductors N.V. - Vice President of Investor Relations [40]

Olivia, I think we'll move to the last question for the call today, please?

Operator [41]

Certainly. And our last question coming from the line of Toshiya Hari with Goldman Sachs.

Toshiya Hari, Goldman Sachs Group, Inc., Research Division - Managing Director [42]

I was hoping you can speak to trends that you're seeing in the China business, particularly around industrial and distribution. I think historically, it had been a fairly volatile part of your business, but clearly, based on your overall Industrial & IoT numbers, you seem to be doing really well. So any sort of puts and takes around -- particularly around the lockdowns, going into it, coming out of it? Any comments would be super helpful.

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [43]

Yes. So first of all, relative to the lockdowns, I mean we had, indeed, also risk-adjusted our quarter 2 guidance, which have to do much more with supply than demand. That was about epoxy suppliers, lead frame suppliers and others. And as you can see from how we managed to make our actuals work, some of that exactly materialized. I mean, indeed, we saw that. However, we see now since June, pretty significant and impactful stimulus programs by the China government, which are starting to take effect. And that's both into the Industrial as well as into the Automotive market. So there is a slight optimism, notwithstanding the risk of further lockdowns, of course, in China.

But from a government stimulus program perspective, there is optimism both for the Industrial as well as for the Automotive markets in China for Q3 and for the second half of the year. I think I mentioned it briefly in my prepared remarks. Our channel inventory is sitting still only at 1.6, which is very low. And mind you that the Industrial business of NXP, and with that especially in China, is dominated by the distribution channel. So a lot of that is in China. And as you can see, it really hasn't moved up much. I think we had 1.5 the last 2 quarters, 1.6 before. So we are still hovering at that very low level, which is a month below our 2.5 target actually.

Toshiya Hari, Goldman Sachs Group, Inc., Research Division - Managing Director [44]

Yes. That's super helpful. And then as my quick follow-up, a separate topic, but on the currency dynamics. Obviously, you've seen the dollar appreciate significantly relative to other currencies. And I recognize that customers don't swap in and out components given long qualification cycles and whatnot. But as we think about the competitive landscape and microcontrollers over the next couple of years, just given how strong the dollar is today, is that something that we should be cognizant of and worried about as you compete with companies like STM and Renesas? Or is that not really a topic that we should be spending too much time on?

William J. Betz, NXP Semiconductors N.V. - Executive VP & CFO [45]

Yes, I'll take that one. Thank you for your question. NXP is a global company. We're U.S.-based. We're naturally hedged against the euro. So I'm not really too concerned about it.

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [46]

All right, so I think that gets us to the end of the call. And let me just highlight once again. We feel we have operated well in the second quarter in a pretty turmoiled environment. We are also very cognizant of the macro crosscurrents, which we also discussed quite a bit in this call. Yes, the outcome is that in the majority side of our revenues, which is the Industrial and Automotive markets, we continue to be sold-out. We think the underlying secular growth trends, especially from content increases both in Industrial and Automotive applications are also providing a pretty safe landing going forward relative to demand.

The one thing which we are very paranoid and very hardworking on is indeed making sure that our inventories down the chain remain low. We think today they are low. We have evidence of this in the channel, with 1.6 months. And our whole focus day in, day out is to make sure that on the one hand, we organize more supply, but on the other hand, we make sure that there is no excess inventory being built in the market down there.

With that, I want to thank you all on behalf of NXP for today's call, and see and speak to you all soon. Thank you very much. Thank you.

Jeff Palmer, NXP Semiconductors N.V. - Vice President of Investor Relations [47]

Thank you very much. This ends our call today. Thanks, everyone. Bye now.

Operator [48]

Ladies and gentlemen, this ends our conference for today. Thank you for your participation. You may now disconnect. Good day.