NXP Semiconductors N.V., Q4 2022 Earnings Call, Jan 31, 2023 (EditedCopy)

TEXT version of Transcript

Corporate Participants

* Jeff Palmer

NXP Semiconductors N.V. - Vice President of Investor Relations

* Kurt Sievers

NXP Semiconductors N.V. - President, CEO & Executive Director

* William J. Betz

NXP Semiconductors N.V. - Executive VP & CFO

Conference Call Participants

* Christopher Caso

Crédit Suisse AG, Research Division - Research Analyst

* Christopher James Muse

Evercore ISI Institutional Equities, Research Division - Senior MD, Head of Global Semiconductor Research & Senior Equity Research Analyst

* Joseph Lawrence Moore

Morgan Stanley, Research Division - Executive Director

* Matthew D. Ramsay

Cowen and Company, LLC, Research Division - MD & Senior Research Analyst

* Ross Clark Seymore

Deutsche Bank AG, Research Division - Managing Director

* Vivek Arya

BofA Securities, Research Division - MD in Equity Research & Research Analyst

* William Stein

Truist Securities, Inc., Research Division - Managing Director

Presentation

Operator [1]

Hello. Thank you for standing by, and welcome to the NXP Fourth Quarter 2022 Earnings Conference Call. [Operator Instructions]

I would now like to hand the conference over to your speaker today, Jeff Palmer, Senior Vice President of Investor Relations. Please go ahead.

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

Thank you, Michelle, and good morning, everyone. Welcome to NXP's Fourth Quarter and Full Year 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 first quarter of 2023. 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 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 fourth quarter 2022 earnings press release, which will be furnished to the SEC on Form 8-K and available from 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]

Thanks, Jeff, and good morning, everyone. We really appreciate you joining our call this morning. I will review both our quarter 4 and our full year 2022 performance, and then I will discuss our guidance for quarter 1.

Beginning with quarter 4, our revenue was [$12 million] better than the midpoint of our guidance with the trends in the mobile and industrial and IoT markets performing better than our expectations, while Automotive was in line and Communication Infrastructure below our expectations. Taken together, NXP delivered quarter 4 revenue of $3.31 billion, an increase of 9% year-on-year while maintaining channel inventory at a 1.6 months level, well below our long-term target.

Non-GAAP operating margin in quarter 4 was a strong 36.5%, 160 basis points better than the year ago period and about 50 basis points above the midpoint of our guidance. Year-on-year outperformance was a result of good follow through on the higher revenue, better gross margin due to higher factory utilization and disciplined expense management.

Now let me turn to the full year performance. Revenue was a record $13.21 billion, an increase of 19% year-on-year. When passing the revenue growth, approximately 14% was due to higher pricing and was due to a combination of volume and mix. And here, as a reminder, we have executed a consistent pricing policy to pass along the inflationary increases of our input costs while not patting our gross margin.

Throughout 2022, we consistently found ourselves in a situation where robust demand across automotive and core industrial markets, outstripped available supply even as production levels, both internally and from our supplier partners improved through the year. And now we do see a continuation of input cost inflation in 2023, however, not at the same pace and level we experienced in 2022.

The full year non-GAAP operating margin was solid 36.3%, a 340 basis point improvement versus the year ago period as a result of higher revenue, improved factory loadings and positive operating leverage.

Now let me move to the specific trends in our focus end markets. First, Automotive. Full year revenue was $6.88 billion, up 25% year-on-year, a reflection of higher pricing, our strong company-specific product drivers and accelerated content increases, thanks to the secular growth in sales of xEV vehicles and prioritization by OEMs of premium class vehicles in a limited supply environment.

For the fourth quarter, Automotive revenue was $1.81 billion, up 17% versus the year ago period and in line with our guidance.

Now moving to Industrial and IoT. Full year revenue was $2.71 billion, up 13% year-on-year, primarily due to higher pricing and the strong competitive positioning of our solution offering comprising industrial processes [indiscernible] connectivity and security. For the fourth quarter, Industrial and IoT revenue was $605 million, down 8% versus the year ago period, so better than our guidance.

Mobile. Full year revenue was $1.61 billion, up 14% year-on-year, primarily due to higher pricing and continued traction of our secure mobile wallet. For quarter 4, Mobile revenue was $408 million, up 9% versus the year ago period and better than our guidance.

Lastly, Communication Infrastructure and Other. Full year revenue was $2 billion, up 15% year-on-year. The year-on-year growth was due to higher pricing and a combination of sales growth of network processors, RFID tech solutions, secured transit and access products and RF power products for the cellular base station markets. For quarter 4, Communication Infrastructure and Other revenue was $494 million, up 8% year-on-year and below our guidance.

Now as discussed earlier, I also would like to provide you a progress update on our accelerated growth drivers. At our Analyst Day in November '21, we highlighted our expectation to grow total company revenue to approximately $15 billion in 2024, coming from $11 billion in 2021 within a compound annual growth range of 8% to 12% over that period. Embedded within this outlook, we highlighted 6 company-specific revenue drivers across all our served end markets, which we anticipated to grow in aggregates to about $6 billion in '24 from a $3 billion level in '21, representing about a 25% 3-year compound annual growth range.

Additionally, we shared with you that our high relative market share core business would grow to $9 billion in '24 from $8 billion in '21, reflecting about a 5% 3-year compound annual growth range. Overall, we are confident to achieve the anticipated growth rates for both our accelerated growth drivers as well as our high relative market share core business.

Moving to the segments. Within Automotive, the accelerated growth drivers are 77 gigahertz radar, electrification and the S32 domain and solar processes, all of which are tracking ahead of plan. According to market research company, Yole, NXP is confirmed as the clear #1 revenue market leader in automotive radar solutions as well as individually in radar RF transceivers and radar processes. Furthermore, we just announced the industry's first 28-nanometer RFCMOS radar 1 chip IC family for the next-generation ADAS, an autonomous driving systems.

Turning to our efforts in electrification. Our sales, including battery management solutions, inverter control and other xEV control processes has doubled year-on-year and achieved record custom design wins.

Finally, within Automotive, the customer enthusiasm for this S32 domain and sonar processor family, enabling the software-defined vehicle, are far in excess of our expectations. This includes the awards by a major automotive OEM, which selected the S32 family of automotive processes and microcontrollers to be used across its fleet of future vehicles beginning mid-decade.

Moving to Industrial and IoT. We are in line with our expected growth range of about 25% 3-year CAGR for our accelerated growth drivers. Both our crossover and [indiscernible] application processor families grew nearly 50% year-on-year in 2022. However, we did see a deceleration in revenue in the consumer IoT portion of the end markets during the second half of 2022.

Finally, we announced our new MCX microcontroller portfolio, that is scalable, optimized foundation for energy-efficient industrial and IoT edge applications, addressing the heavy real-time workloads for the next wave of innovation. In addition, we recently announced our new analog front-end family for high-precision data acquisition and condition monitoring systems for factory automation.

Moving to Mobile. We are below our expected revenue growth range for the accelerated growth driver of ultra-wideband due to the well-documented weakness in the Android handset market, which is the focused mobile market for our ultra-wideband solutions. However, for ultra-widebands, the ecosystem build-out and design win activity and traction in both Mobile and Auto are going well. And we believe as the Android market rebounds, awarded design wins will result in the expected revenue growth for ultra-widebands.

Lastly, within Communications and Infrastructure, we are in line with our expected revenue growth range for RF power amplifiers. The industry transition to gallium nitride from LDMOS technology has occurred faster than expected. The revenue for our gallium nitride-based solutions has doubled year-on-year and demand continues to outstrip our increasing supply capability.

In review, 2022 was a very good year for NXP, with strong execution resulting in record revenue, solid profit growth and a healthy free cash flow generation. Additionally, we experienced unprecedented year-on-year design win traction across the entire portfolio.

Now let me turn to our expectations for quarter 1, 2023. We are guiding quarter 1 revenue to $3 billion, down about 4% versus the first quarter of '22. From a sequential perspective, this represents a deceleration of about 9% 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 mid-teens percent range versus quarter 1, '22 and flat versus quarter 4, '22.

Industrial and IoT is expected to be down in the low 30% range year-on-year and down in the low 20% range versus quarter 4, '22. Mobile is expected to be down about in the mid-40% range, both on a year-on-year and sequential basis. Finally, Communication Infrastructure and Other is expected to be about flat, both on a year-on-year and sequentially.

In summary, as we head into 2023, our Automotive and Core Industrial businesses remain supply constraints in select areas. Within Automotive, the increase of global production levels and the secular adoption of xEV are tailwinds to continued content increases. In Industrial and IoT, we expect relative strength in the core industrial submarkets as our products enable critical infrastructure and companies to be more efficient. However, the Consumer IoT and the Mobile segment will continue to be dependent on a cyclical rebound.

And lastly, in Communications Infrastructure, we expect our supply capability to improve against pent-up demand, specifically in our RFID packing solutions, secure access products and e-government identification.

Within the 5G base station markets, growth in '23 will be dependent on the build-out, especially in India. At the same time, we do believe from an external macro perspective, the general demand environment is offering much higher levels of uncertainty than last year. And in the very short term, we are expecting a dip in China due to the spike in infection rates following the policy shift relating to COVID. Additionally, we expect continued cyclical weakness in demand for consumer-oriented products and a potential correction of customer inventory.

In this more uncertain demand environment, we will focus on prudently managing what is in our control. And especially while we have plenty of orders, we will continue to very vigilantly manage general inventory to a 1.6 months level, which is about a month below our long-term target, equaling approximately $500 million of revenue. We intend to maintain that 1.6 months channel inventory in the first quarter, while we are well positioned with our on-hand inventory to increase channel inventory, if and when demand in China revolves. So far, quarter-to-date, our distribution sales through in China is off to a slow start as is incorporated in our guidance.

Over the midterm, we are cautiously optimistic given customer engagement levels, design win momentum in our strategic focus areas and a potential rebound in China.

And now I would like to pass the call to you, Bill, for a review of our financial performance.

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 revenue during Q4 and provided our revenue outlook for Q1, I will move to the financial highlights.

Overall, our Q4 financial performance was very good. Revenue was slightly 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.

I will first provide full year highlights and then move to the Q4 results. Full year revenue for 2022 was $13.21 billion, up 19% year-on-year. We generated $7.64 billion in non-GAAP gross profit and reported a non-GAAP gross margin of 57.9%, up 180 basis points year-on-year as a result of higher internal factory utilization and fall-through on higher revenue, which is at the high end of our long-term financial model.

Total non-GAAP operating expenses were $2.86 billion or 21.6% of revenue, below our long-term financial model. Total non-GAAP operating profit was $4.79 billion, up 32% year-on-year. This reflects a non-GAAP operating margin of 36.3%, up 340 basis points year-on-year and above our long-term financial model.

Non-GAAP interest expense was $386 million. Cash taxes for ongoing operations were $558 million, noncontrolling interest of $46 million and stock-based compensation, which is not included in our non-GAAP earnings, was $364 million.

Full year cash flow highlights include $3.9 billion in cash flow from operations and $1.06 billion in net CapEx investments or 8% of revenue, resulting in $2.83 billion of non-GAAP free cash flow, up 23% year-on-year or a healthy 21% of revenue.

During 2022, we repurchased 8.33 million shares for $1.43 billion and paid cash dividends of $815 million or 21% of cash flow from operations. In total, we returned $2.2 billion to our owners, which was 79% of the total non-GAAP free cash flow generated during the year.

Now moving to the details of Q4. Total revenue was $3.31 billion, up 9% year-on-year, in line with the midpoint of our guidance range. We generated $1.92 billion in non-GAAP gross profit and reported a non-GAAP gross margin of 58%, up 70 basis points year-on-year and consistent with the midpoint of our guidance range.

Total non-GAAP operating expenses were $713 million or 21.5% of revenue, which is up $32 million year-on-year and down $17 million from Q3, slightly favorable to the midpoint of our guidance. From a total operating profit perspective, non-GAAP operating profit was $1.21 billion, and non-GAAP operating margin was 36.5%, up 160 basis points year-on-year, above the midpoint of our guidance range, reflecting solid fall-through in operating leverage on the increased revenue level.

Non-GAAP interest expense was $95 million, with cash taxes for ongoing operations of $126 million and noncontrolling interest was $12 million. Stock-based compensation, which is not included in our non-GAAP earnings, was $97 million.

Now I would like to turn to the changes in our cash and debt. Our total debt at the end of Q4 was $11.17 billion, essentially flat sequentially. Our ending cash position was $3.85 billion, up $86 million sequentially due to the cumulative effect of capital returns, CapEx investments and cash generation during Q4. The resulting net debt was $7.32 billion, and we exited the quarter with a trailing 12-month adjusted EBITDA of $5.47 billion.

Our ratio of net debt to trailing 12-month adjusted EBITDA at the end of Q4 was 1.3x, and our 12-month adjusted EBITDA interest coverage was 14.9x. Cash flow generation of the business continues to be healthy and our balance sheet continues to be very strong.

During Q4, we paid $221 million in cash dividends and repurchased $475 million of our shares. Additionally, the NXP Board of Directors has approved a 20% increase in our quarterly cash dividend, bringing the quarterly cash dividend to approximately $1 per share. These actions are all aligned with our capital allocation strategy.

Turning to working capital metrics. Days of inventory was 116 days, an increase of 17 days sequentially and distribution channel inventory was 1.6 months. As we mentioned on our last quarter's call, given the uncertain demand environment, we made the intentional choice to limit the months of inventory in the channel, while keeping inventory on our balance sheet to enable greater flexibility to redirect product as needed. Furthermore, given our manufacturing cycle times, combined with the uncertain demand environment in the first half of 2023, we will continue with this approach in Q1, and we expect DIO to increase in the quarter. Days receivable were 26 days, down 1 day sequentially and days payable were 105 days, an increase of 9 days versus the prior quarter due to the timing of material. Taken together, our cash conversion cycle was 37 days, an increase of 7 days versus the prior quarter.

Cash flow from operations was $1.08 billion and net CapEx was $233 million, resulting in non-GAAP free cash flow of $843 million or approximately 25% of our revenue.

Turning now to our expectations for the first quarter. As Kurt mentioned, we anticipate Q1 revenue to be $3 billion, plus or minus about $100 million. At the midpoint, this is down 4% year-on-year and down 9% sequentially. We expect non-GAAP gross margin to be about 58% plus or minus 50 basis points, driven by favorable mix, offset by the lower revenue.

Operating expenses are expected to be about $710 million, plus or minus about $10 million. Taken together, we see non-GAAP operating margin to be 34.3% at the midpoint. We estimate non-GAAP financial expense to be about $77 million. We anticipate the non-GAAP tax rate to be 16.5% of profit before tax. Noncontrolling interest and other will be about $10 million. For Q1, we suggest for modeling purposes, you use an average share count of 261.4 million shares. Taken together, at the midpoint, this implies a non-GAAP earnings per share of $3.01.

For full year 2023 modeling purposes, we suggest for a non-GAAP tax rate you use a range between 16% to 17%. This is lower than our previously anticipated effective cash tax rate of 18% and is based on current tax legislation. For stock-based compensation, we suggest you use $410 million, no change from the model. For noncontrolling interest, we suggest you use $30 million to $40 million lower than 2022 and for capital expenditures, we expect to invest approximately 8% of our revenue.

In closing, looking ahead into 2023, I'd like to highlight a few focus areas for NXP. First, we plan to execute and drive our 6 company-specific accelerated growth drivers. Second, we will manage our internal and channel inventory thoughtfully based on market conditions. Thirdly, we will continue to be disciplined with our operating expenses, while protecting our long-term R&D investments. Taken together, we plan to operate within our long-term financial model ranges in what is a dynamic macro environment.

I'd like to now turn it back to the operator for questions. Thank you.

Question And Answer

Operator [1]

[Operator Instructions] Our first question comes from Christopher Caso with Credit Suisse.

Christopher Caso, Crédit Suisse AG, Research Division - Research Analyst [2]

I guess to start, Kurt, perhaps you could speak to your comments on managing the channel inventory. And of course, one of the concerns investors naturally have is the worry that customers order more than they need given the constraints at the present over the last year and then potentially you overship that. Can you speak to how you're ensuring that what you're shipping to customers now is actually going to real demand rather than inventory? And I guess that's particularly as some of the foundry capacity loosens up, gives you a little -- a little more access to wafer supply.

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

Yes. Thanks, Chris, and thanks for taking the first question. Yes, the very, very vigilant management of the channel inventory, it's a very deliberate choice Bill and I took. And we do this while we have more than enough orders at hand to actually ship, say, another $500 million in the quarter into the channel and still hitting our target of 2.4 or 2.5 months of inventory. But we take the choice because we specifically now in China see a weakness. Actually, we think the weakness in China, which for us is almost entirely distribution. We see that connected to the change of COVID policy, which they took in early or first half of December and the spike of infection rates following that. And we just want to be responsible through this period of weakness in China, but watching the situation very carefully.

So as soon as we would see signs of consistent rebound in China, we have both the orders, but also the product at hand to actually fill back the channel. So it's kind of our choice, which we took here, and I have to say this is across all segments. So that weakness, which we see in China, is not really segment, distribution specific across the board related to this policy change and infection spike in China.

Maybe important to highlight that at the very same time, we are seeing across the board very strong trends in our direct customers. So it's -- we have a very diverging -- last quarter, we spoke about the dichotomy, very diverging picture now that from a segment perspective, Auto and Core Industrial remain strong. But now we have an additional effect here that we see this short-term weakness in China, which we try to be prudent about with the choice of the channel inventory stable.

Christopher Caso, Crédit Suisse AG, Research Division - Research Analyst [4]

Got it. As a follow-up, if I could pivot to Auto. And question is what's a reasonable expectation for Auto revenue for the year, if not quantitatively, at least qualitatively? And it was flat last quarter, you're managing to be flat again. Is it -- should it stay flat from here? Are you trying to get additional capacity in the process nodes needed for Auto. So that quarterly revenue would at one point rise and catch up on that backlog?

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

Yes. Let me give you some color on Q4, Q1 and then directionally for the year. Indeed, Q4 was flat from a quarter-on-quarter perspective, by the way, nicely up year-on-year really because of supply constraints. I mean we just did -- we couldn't ship more because we didn't have more products in Q4. In Q1, it's a bit more of a mixed bag. We are getting more products. But at the same time, we -- Automotive in China distribution falls under what I said earlier. So we have a bit of a decline when you think about Automotive distribution in China, while the rest is actually going up at the same time. In the mix, it turns out to be then flat quarter-on-quarter and again, nicely up from a year-on-year perspective.

Maybe more importantly, for the full year, yes, we are optimistic, Chris. We see, according to IHS, a far increased to about 85 million, so I think 82 million cars last year, going to 85 million this coming year, which is 3.5-or-so percent increase and more importantly, definitely a continued increase of xEV, electric vehicle penetration. Again, according to IHS, I think going to 35% of the total car production having hybrid or fully electric drivetrains, which is significant and continues to be a significant boost from a content perspective for us.

At the same time, we are gradually as through the last quarters, getting access to more supply. I dare to say from today's perspective that probably through the end of the calendar year '23, I hope we have most of the shortages behind us. I mean that will never be totally complete, but I think we are getting closer to a better balance towards the end of the year. And finally, pricing continues to play a role. I think I talked about the pricing specifics for last year in my prepared remarks.

Now when you think about this year, input cost continues to go up, especially in those areas which continue to be tight from a supply perspective. So there is also, specifically in Automotive, continued pricing tailwind to be expected.

Operator [6]

Our next question comes from Vivek Arya with Bank of America.

Vivek Arya, BofA Securities, Research Division - MD in Equity Research & Research Analyst [7]

Kurt, when I look at the 2 areas facing the most headwind, Consumer IoT and Mobile, and I think they could be below 20% of sales as you get into Q1. Should we assume that is sort of the cycle look when I look at Mobile, I think it's back to like Q1 '19 level? So do you think Q1 kind of marks the cycle low for these 2 most problematic areas? Or do you see them slipping further in Q2?

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

Honestly, Vivek, we don't know. I would go over my skis to make a firm statement here. But indeed, Mobile, of course, has a couple of specifics which are driving it really low. There is a seasonal element to this, obviously. Secondly, we do have in Mobile executed our NCNR orders last year, which gives us a headwind from an inventory perspective, if you will. We firmly executed these NCNR orders because these are custom-specific products where we have no chance otherwise to move them around and give them to other customers.

And then finally, there is the well-known and documented Android weakness, which continues to be. I'd say the following: as you see, we are very disciplined with customer inventory and mind you that our Mobile business, to the largest extent, is going through the channel. So if and when end demand picks up, rebounds, which I think it will, at some point, we should indeed very quickly see it. Is that exactly for the second quarter? I don't know, but we are very close to the pipe, given the way how we treat this. I mean I'm glad you are asking, Vivek, because this whole thing around our almost brutal discipline on the 1.6 channel inventory moves us very close to as soon as there is pickup in end demand, we will also see it in our numbers.

Vivek Arya, BofA Securities, Research Division - MD in Equity Research & Research Analyst [9]

Got it. And then on gross margin, I think, Bill, you mentioned something about mix that is helping you keep gross margins at the high end of your target range of 58%. So conceptually, let's say, if your Q1 is the bottom-in sales and sales are flat to up from here. Then do you think gross margins can stay at 58%? Or do you think there is something in mix or utilization in the following quarters that can change gross margins below this level? Or it's 58% kind of now the new baseline of gross margins for NXP?

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

Vivek, thank you for your question. Let me talk about Q4 and the Q1 guide and also looking ahead. First, as you know, we did slightly better than our guidance and I mentioned it was improved by product mix for Q4. Again, as we look into Q1, despite those lower revenues, we see this positive product mix offsetting lower fall-through on the revenue. Also, we have lowered our internal front-end utilization rates. In Q3, we were running in the high 90s. In Q4, we're about 90%. And again, remember, this is all linked to that non-auto industrial type of products because of market softness we're seeing.

For Q1, we do expect to lower our front-end utilization again to about 85%, which is where we still remain constrained in our internal auto IP processing technologies and so forth. And again, I'd say, looking ahead, we expect to stay within our long-term gross margin forecast of 55% to 58% as our cost structure today is more variable in nature than the past. Also, our factories, if you think about it, become more efficient when they run at normal utilizations and we have a disciplined inventory approach with their channels. So we're going to stay with that range. We're not revising it, but we feel very good about our gross margin performance.

Operator [11]

Our next question comes from Ross Seymore with Deutsche Bank.

Ross Clark Seymore, Deutsche Bank AG, Research Division - Managing Director [12]

Kurt, I want to go back to your core Automotive and, I guess, Core Industrial business, not the consumer IoT side. I believe you said the demand was largely holding in well there, except for some of the channel dynamics in China. I guess overall, is that true? Is the core industrial especially holding in? And how do you delineate between the channel weakening and isolating that to a variable other than demand?

Obviously, you can see this is coming out of China, and we know the COVID policy. But to the extent it's weakening, people aren't really going to care if the source is coming from [indiscernible] having too much inventory or OEM [indiscernible]. Either way, it's kind of slowing even though the latter could by some sort of a temporary aspect. So any sort of color you could give on your core demand would be helpful?

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

Yes. Thanks, Ross. It is actually easier to speak to this in Automotive because we have a much larger portion of direct customers where we can also triangulate with the demand from the OEMs, from the end customers.

And we have these discussions actually with all 3 parties on the table. So we cannot be misled by inventory builds or anything from the Tier 1s because we really cleaned this out now all the way to the OEMs and I think what I said to Chris earlier about the optimism on the Auto business through the year is the answer to your question. So there is a short-term disturbance in China, but that's really more about the distributors than anything else when it comes to Automotive.

In Core Industrial, Ross, it is indeed harbor to be that specific because the majority of our business goes through the channel. So it is much harder to say from the perspective of what do we know from end customers really, which is also why into Q1, I'd say also Core Industrial probably drops sequentially. But again, it is very hard to decompose this from the China situation. So it could just be because of this particular China situation since we have such a high exposure in Industrial -- also in Core Industrial to China.

I can, however, tell you that the direct accounts in the Core Industrial business, but they are a minor portion of our business. They are holding up quite well. So for that reason, you could say there is some data points, which would tell us that also Core Industrial is robust. But I have -- it's less certain given the channel exposure, which we have in that segment.

Now from a content increase perspective from -- if you think more from a macro perspective, what these applications are doing in critical infrastructure in driving efficiency of industrial customers, I think there is any reason to believe that we should also for Core Industrial continue to be optimistic for the year.

Finally, what I said about pricing earlier, pricing for Automotive holds true also for Core Industrial. Similar technologies, similar continued pressure on supply, which is very different, obviously, to the Consumer and Mobile businesses.

Ross Clark Seymore, Deutsche Bank AG, Research Division - Managing Director [14]

I guess one kind of on utilization, inventory and gross margin all tied into one for Bill. It's impressive to see that your utilization is dropping and your gross margin is still staying at 58%. I guess, in the DIOs, is there a limit to which you would go on the upside there? I know your long-term target is 95%. I also know that you've been very clear as to why you're going above that right now. But is there a limit to how high you would go on days of inventory internally before you'd really have to ratchet the growth -- the utilization down? And if so, how does that fold into what the gross margin that would be the outcome in that scenario?

William J. Betz, NXP Semiconductors N.V. - Executive VP & CFO [15]

Thanks, Ross. Yes, you are correct in a way that when we look at inventory, we look at both the internal and the channel together. So as you can imagine, right, the channel inventory today at 1.6 months, basically, we can move that up by about another 25 days if we wanted to, to our target of 2.5 months of sale.

Clearly, with the softness in several of the areas, we are monitoring this. We're keeping it strategically on our channel. And as Kurt mentioned, as conditions do approve, we will release some of that and want to go sell-through one-to-one. Now the good news is the inventory we have on hand is all long lived and has very low obsolescence risk. At the same time, I'd say, unfortunately, we're still constrained in several selective nodes.

Remember, we buy about 60% externally. We do about 40% internally. That 40% really -- more than 2/3 of that internal capacity is linked to Auto and Industrial. So that's going to keep us at nice levels of utilization for the rest of the year. So again, we're going to be more flexible, yet disciplined to support our customer service levels and the potential for future growth. But to give you an example, right, if we have the orders, as Kurt mentioned, and we shipped that $500 million and went to 2.5 months of sales, assuming none of it sells through, this would basically have an effect on our revenue and our COGS and basically say NXP's internal inventory would have been below 90 days.

So you have to look at them combined. We're doing this very proactively and intentionally to prevent inventory buildup. So I think from an internal DIO, if we kept the channel at 1.6, I'm comfortable holding probably another 15 to 20 days on top of the level that you see today.

Operator [16]

Our next question comes from C.J. Muse with Evercore.

Christopher James Muse, Evercore ISI Institutional Equities, Research Division - Senior MD, Head of Global Semiconductor Research & Senior Equity Research Analyst [17]

I guess a follow-up question on gross margins. You started the call talking about expectations for higher ASPs given higher input costs. It sounds like you're very optimistic around accelerated growth areas that should benefit mix. You've cut back utilization, and it sounds like that should trend higher over time, and that's focused more on proprietary mixed signal, which I assume, again, is better mix. And then you guided CapEx essentially flat to down year-on-year, which means depreciation shouldn't be moving higher. So the question is this, I guess, are there any kind of headwinds to gross margins that we should be thinking about in '23?

William J. Betz, NXP Semiconductors N.V. - Executive VP & CFO [18]

I mean the only thing I would say that could cause gross margin to go below the long-term model that 55% to 58% is probably a prolonged global recession, that affects all of us, right? But if we're having the -- what we're seeing right now, we think we'll -- we will and plan to stay within that 55% to 58%, C.J.

Christopher James Muse, Evercore ISI Institutional Equities, Research Division - Senior MD, Head of Global Semiconductor Research & Senior Equity Research Analyst [19]

And I guess as my follow-up, on the Comm Infrastructure and Other line, can you give a little more color on what led to the weakness in December? And how we should be thinking about the different moving parts for that business for all of '23?

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [20]

Yes, C.J. I'm Happy to do that. Q4 was purely supply. We were a bit ahead of our, say, skis with the guidance because we know that more supply is coming up, and that's also why Q1 is now going much better. And that -- there were some operational issues and we didn't get it going in Q4. So Q4 fail against guidance had nothing to do with demand, that was purely about a supply base.

Now going forward, it is indeed such that I would say we are cautious when it comes to the radio power part of the business because the one area where we see build-outs in network infrastructure this year then it's India. So it's all about to what extent at what pace is this going to happen through the year. What is for sure is that it is much more and much faster leaning to gallium nitride versus LDMOS, which is favoring us and we just have to do a good job in increasing our supply capability to actually run up here.

The one other piece within this Comm Infra and Other segments, which will matter this year, is actually the RFID tagging, secure and access cards and government identity products. There is a significant amount of pent-up demand C.J., which we could not serve the last 2 years which was our choice. I mean it is a technology which we have to use for other segments and other products. That is a classic demand, which doesn't disappear because it is about infrastructures, it is about government IDs, which people need around the world. So the demand is still there. Now we are actually moving the supply capability from other areas where the demand has softened into this and we are starting to serve it. So from a subsegment dynamic perspective, C.J., think about this part being the one which is actually going to generate growth this year.

Operator [21]

Our next question comes from Joseph Moore with Morgan Stanley.

Joseph Lawrence Moore, Morgan Stanley, Research Division - Executive Director [22]

I think you've talked about being for your Auto business having backlog coverage for the year with the disruption in China, kind of would you still say that's the case? And as a follow-up, how are you guys thinking about NCNRs on your backlog this year? How flexible are you going to be if, for example, the China situation causes people to want to reschedule deliveries?

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

Yes. So Joe, first of all, the supply capability through the year. Clearly, the number of escalations has moderated. We still have a number of nastily short technologies. And I would call out 180 nanometers, 9055 gallium nitride and the high-voltage analog mixed signal, which is proprietary to NXP. This is, of course, in size less than it used to be, but it still leads to significant customer escalations and shortages, which we think will go through the year, but hopefully moderating towards the end of the year.

If we translate this back into supply capability, I think we said on the last call, we would be able to serve about 85% of kind of risk-adjusted backlog for the year. I'd say for this year, for '23, this is now more like 90% to 95%. So you see it's better. It's not yet on target. We are not yet in a position that we have visibility to serve everything we want, but we are coming closer.

Now you might be confused with the high DIO and still me saying that we can't serve Automotive. The matter of the fact is that if you would pass it the DIO in 2 segments. And I mean, I will not give you numbers, but the auto part of it, so the product which is specific to the lease in Automotive is actually well below target. So it's just very variable between the segments, and it's not fungible, as you know.

Now that leads me to the second part of your questions around NCNRs. I gave you one example earlier where we have very strictly executed NCNRs and that was the Mobile last year, which indeed is a bit of a headwind now getting into this year because product was not fungible. I mean it's customized in software, so there was no way to let customers of the book. Going through this year, there is not a one-fits-all answer, Joe. So I'd say we are flexible if the product is fungible. I mean we do not force one customer to absolutely take it if we can at the same moment, sell the same product to somebody else. I mean, that wouldn't make sense.

We are very strict if it would go against any take-or-pay liabilities, which we have to our suppliers. I mean there is no way we would let our customers off the hook. Then it depends on overriding commercial agreements, which we have with customers, in some cases, which might be of forcing functions. And then -- and that's especially in Automotive, which is a large part of our NCNR backlog. We are working with ODMs. So if a Tier 1 comes to me and says, I want to discuss about the NCNR level, I say, okay, then we discussed together with your end customer. And we want to understand if that is in the best interest also for the end customer which puts quite a bit of pressure on the system and actually enforces some of the NCNR through that channel.

So you will see -- I cannot say the 100% always in force. We would not do this where you would see that we create a problem for ourselves later. I mean that's the same philosophy, which we are applying with the travel inventory. Why would we? I mean that wouldn't be smart. But in many cases, we still do, given the dynamics I just mentioned.

Operator [24]

And our next question comes from William Stein with Truist.

William Stein, Truist Securities, Inc., Research Division - Managing Director [25]

The last couple of questions in particular are very helpful in understanding the sort of shape of demand. I'm hoping maybe we can talk a little bit about longer-term competitive dynamics, in particular, in the Automotive end market, you seem to be doing well in these growth areas. But Kurt, I'm hoping you can talk more about your position with the emerging Chinese OEMs, which especially in EVs have started to deliver some very strong growth. Can you compare your competitive positioning with those OEMs relative to how you've done historically with the bigger global ones?

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [26]

While -- Will, while I cannot speak on a customer-specific level, obviously, I dare to say when I look at the win rates and the shipment rates, we are very well balanced when it comes to EVs, both geographically but also between, say, big OEMs and start-ups. And that has been an attention point for me right from the start because actually, many years back already I always thought that China might become a leading force in electrification, given that they didn't have the legacy to change their companies from combustion engines to electric drivetrains. I mean that is a significant advantage.

And so for many years already, we tried to stay very close to start-up companies, which, by the way, is not just in China, but that's often between China and California. I mean there is a lot of combined companies there. So, no, I would not say that we have a, if you will, negative buyers only to the big guys and would not participate in the growth provided by start-ups, which largely are in China. It has also to do with our product portfolio, Will. I mean, we are so broad and so leading in automotive, how would we only work with one part of the market. It's almost impossible. So no, that's not the case. I'm optimistic here.

Operator [27]

And our next question comes from Matt Ramsay with Cowen.

Matthew D. Ramsay, Cowen and Company, LLC, Research Division - MD & Senior Research Analyst [28]

Kurt, in your prepared script, you referenced the model from the Analyst Day sort of the $15 billion in revenue in 2024, and sort of reiterated the targets for sort of the core business and the new growth areas. But as we start on a sort of $12 billion run rate, and I know a couple of the segments are really down in the first quarter. But just on an annualized basis, I think we need to get to 6%, 7% growth or something like that for this year and next to hit that target. So maybe you could just give us a little more color on the specific drivers, not just in the next quarter or 2, given the volatility, but over the next, like, 24, 36 months of how you see getting there from where we're starting?

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [29]

Yes, Matt. So indeed, I mean, the Q1, given China and everything we discussed in the last 25 minutes is indeed a bit of a -- probably a bit of an outlier. I think the growth rates, which contribute to the 8% to 12% for the company, being led by Automotive and Industrial IoT, that is still how we look at the growth for the next 3 years. So we do believe that if you look across NXP, the content increases and our strong position in Automotive will let automotive growth above corporate average. I think we said 9% to 14% relative to the 8% to 12% for the total. Since this is half of the company, Matthew will understand that, that has a significant dynamic for us.

And in Automotive, it's also fair to say, and I gave you some details for last year that pricing is a positive further contributing element, which maybe was not always fully comprehended in the initial forecast.

And in a similar way, I would speak to Core Industrial, mind you, that is 60% of the Industrial IoT segment. There, indeed, and that's maybe where your question was going to the more cyclical businesses being the consumer IoT as part of industrial IoT segment as well as Mobile, there it will all depend on timing. I mean we really have to see what the timing of a rebound is going to be. Where at the same time, if you look at history of these segments, they are very fast moving.

I mean you can very quickly have significant changes through the quarters, especially when China makes a move. But again, strategically, I think the growth algorithm guiding us to the 8% to 12% for the company is pretty much intact. There possibly automotive has a bit more momentum even than we would have anticipated in the first place.

Matthew D. Ramsay, Cowen and Company, LLC, Research Division - MD & Senior Research Analyst [30]

Got it. Just a quick follow-up for Bill. You guys pretty tight on OpEx in the first quarter. I think maybe a tiny bit above the 16% and 7% of revenue that you sort of laid out in the model, Bill, but on a pretty big down revenue quarter in a couple of segments, we potentially reaccelerate off the bottom in a couple of the segments that are challenged in China. Have you -- are you going to reaccelerate OpEx at the same rate? Or is there a sort of -- how should we think about that into the back half as the revenue potentially recovers?

William J. Betz, NXP Semiconductors N.V. - Executive VP & CFO [31]

Thanks, Matt. Let me address operating expenses. I think we continue to manage our operating expenses pretty well with the uncertainty in the macro markets. So in Q4, we were a bit more favorable than our guidance driven by the lower variable compensation, and we managed our discretionary spend. In Q1, we're keeping our OpEx relatively flattish, I would say despite you all know the typical headwind that we experienced in the U.S. employee benefit rates and so forth. So we're doing a good job there.

And as I mentioned in my opening remarks, we are going to navigate and control our spend. It's one of those levers that we have. And for 2023, I'd say we'll plan for the full year to make sure that we're below that 23% for modeling purposes. So maybe a quarter here, it may go out of balance, but for the full year, we expect to be within 23%.

Operator [32]

Our next question comes from Stacy -- yes, sir?

Jeff Palmer, NXP Semiconductors N.V. - Vice President of Investor Relations [33]

That will be our last question. We'd like to pass it over to Kurt for some final remarks -- get right here to the end.

Kurt Sievers, NXP Semiconductors N.V. - President, CEO & Executive Director [34]

Yes. Thank you -- thank you very much, Jeff. Now as we have discussed, clearly, the level of uncertainty currently is higher than what we've had through the past couple of quarters. The stance we take is that we want to be prudent and disciplined to those elements, which are in our control. We just discussed about OpEx. But much more importantly, I think this is all about inventory management. There, we don't want to be blocked by a lot of over shipping into the channel and not having a [deal] anymore what the true end demand is. So that's why we focused on this call and also for our guide very much on that approach.

For the channel, which mind you, is more than 50% for NXP, more than 50% of our revenues are going through the channel. So that discussion is a very important piece for us. With that, we are actually in a position to certainly navigate in a good way through this period of uncertainty and at the same time, remain very prepared for a potential rebound which we think could happen in the time to come, especially in China when the infection rates come down again after this policy change. With that, thanks for your attention. Thank you very much. I speak to you all soon. Thank you.

Jeff Palmer, NXP Semiconductors N.V. - Vice President of Investor Relations [35]

Thank you, everyone. We can disconnect now. .

Operator [36]

Thank you for your participation. This does conclude the program, and you may all disconnect. Everyone, have a great day.