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Microchip Technology Incorporated (MCHP) CEO Steve Sanghi on Q2 2020 Results - Earnings Call Transcript

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FQ2: 11-05-19 Earnings Summary

Press Release *10-Q*

EPS of $1.43 misses by $-0.01 | Revenue of $1.34B (-11.60% Y/Y) misses by $-14.4M

Earning Call Audio

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Microchip Technology Incorporated (NASDAQ:MCHP) Q2 2020 Earnings Conference Call November 5, 2019 5:00 PM ET

Company Participants

Eric Bjornholt - Chief Financial Officer and Vice President, Finance

Ganesh Moorthy - President and Chief Operating Officer

Steve Sanghi - Chairman and Chief Executive Officer

Conference Call Participants

Chris Caso - Raymond James

Gary Mobley - Wells Fargo Securities

Vivek Arya - Bank of America

Harsh Kumar - Piper Jaffray

Shawn Harrison - Longbow Research

William Stein - SunTrust Robinson Humphrey

Harlan Sur - JPMorgan

Mark Delaney - Goldman Sachs

John Pitzer - Credit Suisse

Christopher Danely - Citigroup

Vijay Rakesh - Mizuho Group

Christopher Rolland - Susquehanna International Group

Gilbert Alexandre - Darphil Associates

Carlin Lynch - B. Riley FBR

Craig Hettenbach - Morgan Stanley

Operator

Good day, everyone, and welcome to the Microchip's Second Quarter Fiscal 2020 Financial Results Conference Call. As a reminder, today's call is being recorded.

At this time, I would like to turn the conference over to Microchip’s Chief Financial Officer, Mr. Eric Bjornholt. Please go ahead, sir.

Eric Bjornholt

Thank you and good afternoon, everyone. During the course of this conference call, we will be making projections and other forward-looking statements regarding future events or the future financial performance of the company. We wish to caution you that such statements are predictions and that actual events or results may differ materially.

We refer you to our press releases of today as well as our recent filings with the SEC that identify important risk factors that may impact Microchip's business and results of operations.

In attendance with me today are Steve Sanghi, Microchip's Chairman and CEO; and Ganesh Moorthy, Microchip's President and COO. I will comment on our second quarter fiscal year 2020 financial performance. And Steve and Ganesh will then give their comments on the results, discuss the current business environment as well as our guidance and provide an update on the ongoing integration activities associated with the Microsemi acquisition. We will then be available to respond to specific investor and analyst questions.

We are including information in our press release and this conference call on various GAAP and non-GAAP measures. We have posted a full GAAP to non-GAAP reconciliation on the Investor Relations page of our website at www.microchip.com, which we believe you will find useful when comparing our GAAP and non-GAAP results. We have also posted a summary of our outstanding debt and leverage metrics on our website.

I want to remind investors that during the June quarter of 2018, we adopted the new GAAP revenue recognition standard which requires revenue to be recognized at the time products are sold to distributors versus our historical revenue recognition policy where revenue on such transactions was deferred until the product was sold by our distributor to an end customer.

As discussed in previous earnings conference calls, we continue to track and measure our performance internally based on direct revenue plus distribution sell-through activity and each quarter we'll provide a metric for this called end-market demand in our earnings release. Therefore along with our GAAP and non-GAAP results based on distribution sell-in, we will also provide investors with our end-market demand based on distribution sell-out but will not provide a P&L based on end-market demand.

End-market demand in the September 2019 quarter was $1.346 billion. End-market demand was about $8.6 million more than our GAAP revenue in the quarter. I will now go through some of the operating results including net sales, gross margin and operating expenses. I will be referring to these results on a non-GAAP basis, which is based on expenses prior to the effects of our acquisition activities, share based compensation and certain other adjustments as described in our press release.

Net sales in the September quarter were $1.338 billion, which was down 1.15% sequentially and modestly below the midpoint of our guidance of $1.349 billion. We have posted a summary of our GAAP net sales and end-market demand by product line and geography on our website for your reference.

On a non-GAAP basis, gross margins were near all-time highs at 62.24%, operating expenses were at 25.56% and operating income was 36.7%. Non-GAAP net income was 365.7 million. Non-GAAP earnings per diluted share was $1 43, which was in line with the midpoint of our guidance.

On a GAAP basis, gross margins were 61.9% and included the impact of 5.2 million of share based compensation. Total operating expenses were 643.9 million and include acquisition and tangible amortization of 248.2 million, special charges of 3.6 million, 10.1 million of acquisition related and other costs, and share based compensation of 40.1 million. The GAAP net income was 108.9 million or $0.43 per diluted share.

Our September quarter, GAAP tax benefits included 12.7 million of net discrete income tax benefits related to tax reserve releases, due to statute of limitations expiring, partially offset by a foreign tax assessment. The non-GAAP cash tax rate was 6.5% in the September quarter and was negatively impacted by foreign tax assessment that Microchip will pay in fiscal year 2020, but defendant’s position and seek a refund of these taxes in the future. We expect our non-GAAP cash tax rate for fiscal '20 to be between 6% and 7%. Exclusive of the transition tax, any potential tax associated with restructuring the Microsemi operations into the Microchip global tax structure, and any tax audit settlements related to taxes accrued in prior fiscal years. We have many tax attributes and net operating losses and tax credits, as well as U.S. interest deductions that we believe will keep our cash tax payments low. The future cash tax payments associated with the transition tax is expected to be about 236 million and will be paid over the next six years. We have posted the schedule of our projected transition tax payments on the Investor Relations page of our website.

Our inventory balance at September 30, 2019 was 734.2 million. We had 131 days of inventory at the end of the September quarter, down one day from the prior quarter's level. Inventory at our distributors in the September quarter were at 30 days compared to 32 days at the end of June. We have only had one quarter in the past 15 years, which was Q3 of fiscal year 2013, our days of inventory at distribution have been lower than the current levels.

The cash flow from operating activities was 396 million in the September quarter. As of September 30, the consolidated cash and total investment position was 405.1 million. We paid down 315.5 million of total debt in the September quarter, and the net debt on the balance sheet was reduced by 283.5 million. Over the last full five quarters, since we closed the Microsemi acquisition and incurred over $8 billion in debt to do so, we have paid down 1.729 billion of the debt and continue to allocate substantially all of our excess cash beyond dividends to aggressively bring down this debt.

We have accomplished this despite the adverse macro and market conditions during most of this period, which is a testimony to the cash generation capabilities of our business. We expect our debt levels to reduce significantly over the next several years. Our adjusted EBITDA in the September quarter was 540.2 million, and our trailing 12 month adjusted EBITDA was 2.178 billion. Our net debt to adjusted EBITDA excluding our very long dated convertible debt that matures in 2037 and as more equity like in nature was 4.59 at September 30 2019. Our dividend payment in the September quarter was 87.3 million.

Capital expenditures were 17.7 million in the September quarter. We expect between 20 million and 25 million in capital spending in the December quarter and overall capital expenditures for fiscal 2020 to be between $90 million and $100 million, a $25 million reduction from the forecast we provided last quarter.

We continue to add capital to support the growth of our production capabilities of our new products and technologies and to bring in house more of the assembly and test operations that are currently outsourced. We expect these capital investments will bring some gross margin improvement to our business, particularly for the outsourced Actel and Microsemi manufacturing activities that we are bringing into our own factories. Depreciation expense in the September quarter was 39.5 million.

I will now turn it over to Ganesh to give us comments on the performance of the business in the September quarter and provide an update on some of our ongoing Microsemi integration activities. Ganesh?

Ganesh Moorthy

Thank you, Eric. And good afternoon, everyone. Before I get started, I'd like to remind you that the product line comparisons I will be sharing with you today are based on end-market demand, which is how Microchip measured its performance internally. Also, as I go through the product line reports, they will reflect continued broad macro weakness in the markets we serve. This broad weakness was further accentuated in the month of September.

Let's start by taking a closer look at microcontrollers. Our microcontroller business was sequentially down 1.3%, as compared to the June quarter. We continue to introduce a steady stream of innovative new microcontrollers, including the industry's first commercially available serial memory solid-state drive controller, which won the Best-of-Show award in the 2019 Flash Memory Summit, as well as two different USB Type-C Power Delivery controllers, which enabled fast device charging and simplifies implementation of this functionality. Microcontrollers represented 53.3% of our end-market demand in the September quarter.

Now moving to analog. Our analog business are sequentially up 0.2% as compared to the June quarter. During the quarter, we continue to introduce a steady stream of innovative analog products, including the introduction of the Trust Platform for CryptoAuthenticaion, the industry's first pre-provision solution providing secure key storage for small and large volumes. Analog represented 28.7% of our end-market demand in the September quarter,

Our FPGA business was sequentially down 8.9%, as compared to the June quarter. As we have mentioned in prior conference calls, the FPGA business does have some lumpiness, because of a significant exposure to space, aviation and defense markets where procurement timing can be a function of programs and they're shifting priorities, schedules and budgets.

During the quarter, we announced our Smart Embedded Vision initiative, providing for designing intelligent machine vision systems with our low power PolarFire FPGAs. Design wins for the PolarFire family continue to grow strongly. And we remain optimistic about the prospects for this product family. FPGA represented 6.8% of our end-market demand in the September quarter.

Our licensing memory and other product line which we refer to as LMO was sequentially up 10.5% in the September quarter, as compared to the June quarter. Strength in our licensing business, as well as our timing systems business outpaced the broader macro weakness we experienced. LMO represented 11.2% of our end-market demand in the September quarter.

In September, we completed the acquisition of two small early stage private companies. The first acquisition enables low power embedded computing solutions for machine learning inference, and smart embedded vision applications for our FPGA product families. This acquisition also adds domain knowledge depth in the areas of machine learning algorithms and vector processing.

The second acquisition provides digital gate driver solutions for wide bandgap MOSFET and IGBT Technologies. The acquisition complements our silicon carbide discrete and modular power conversion offerings, and enables us to provide more comprehensive total system solutions.

These two acquisitions were very small and more akin to acquiring intellectual property along with domain experts to help us accelerate our business agenda in specific laser focused areas. The combined cash outflow was less than $6 million and hence not material to the rate at which we're paying down our debt.

Finally, a quick update about the ongoing Microsemi integration. We continue to plow forward with the business systems and operations integrations. On the business systems front, we went live with a few more systems on November 1. And as I mentioned on prior conference calls, this is a tedious and time consuming effort and we estimate that we're about 50% of the way to completion and have about another year of work ahead of us. We are pleased with the synergies we have achieved since we close the transaction, despite the week of macro environment, and we expect continued synergy gains for many quarters to come.

Let me now pass it to Steve for his comments about our business and our guidance going forward. Steve?

Steve Sanghi

Thank you, Ganesh, and good afternoon, everyone. Today, I would like to first reflect on the results of the fiscal second quarter of 2020. I will then provide guidance for the fiscal third quarter of 2020.

Our September quarter GAAP net says based on selling revenue recognition was $1.338 billion, up 1.15% sequentially versus a guidance of flat to a 4%. So we missed the GAAP sales guidance slightly at the midpoint. Our end-market demand based on sell through was $8.6 million higher than GAAP sales, which we believe shows that the channel is continuing to manage the working capital conservatively by reducing inventory, due to uncertainty.

Recall that we call the bottom of the cycle back in February of 2019, contingent on resolution of the U.S. China trade dispute. This trade settlement did not happen and remains unresolved. Since then, our end-market demand has been flat at 1.34 billion, 1.35 billion and 1.346 billion for March, June and September quarters respectively, due to multitude of headwinds from trade tensions, and resulting impact on automotive industrial and consumer appliance end-markets.

Our consolidated non-GAAP gross margin of 62.24% was just above the high end of our guidance and was near a record high. Our consolidated non-GAAP operating margin of 36.7% was also higher than the midpoint of our guidance of 36.2%. The integration of Microsemi continues to proceed very nicely. Since the closing of the acquisition, we are continuing to see strong synergies and improvements in growth and operating margins for Microsemi products. Our consolidated non-GAAP earnings per share was $1.43 right at the midpoint of our guidance. On non-GAAP basis, this was also our 116 consecutive profitable quarter.

In the September quarter, we paid down $315.5 million of our debt. Our total debt payments since the end of June 2018 has been $1.73 billion. The pace of debt payments has been strong, despite the weekend uncertain business conditions as we continue to squeeze working capital.

Now before I provide you guidance for the December quarter, let me comment on geographical and end-market sales. While the uncertainty begins with U.S. China trade friction, the uncertainty has become global. The week business conditions can be seen in all geographies. Our Americas business in September quarter based on end-market demand was down 6.1% over a year ago quarter, Europe was down 12.9%, and Asia was down 12.6%. We did expedience our business being weaker in September than we had expected in the month of September. This weakness was also reflected in the lower studying backlog for the December quarter as well as the unusually low distribution inventory exiting the September quarter.

From an end-market standpoint, industrial, automotive and consumer appliances end-markets are down significantly, aerospace and defense and communication markets have been flattish, and data center market has been strong. The uncertainty in all geographies is continuing. In this environment, direct customers and especially the distributors are continuing to manage the working capital by reducing inventory.

However, there are some signs of inflection point too. In the September quarter, distributor inventory was down to 29.6 days. We have had only one quarter in the past 15 years, which was the third quarter of fiscal year 2013, where our days of inventory at distribution have been lower than the current levels.

Secondly, booking for the month of October were the highest booking achieved since June of 2018. While the backlog for December quarter is much lower than the backlog for September quarter, at the same point in the quarter, the slope of the backlog fill for the current quarter is much steeper. With steeper backlog fill, where the backlog in shipments end up is a guessing game, especially with the holidays coming. Our judgment is that the net sales based on selling revenue recognition will take another leg down this quarter. But with several indicators showing inflection point, we may see the forming of a bottom here even though we saw a false bottom back in the March of this year when trade dispute was not resolved.

We expect GAAP net sales based on selling revenue recognition for our products to be between minus 2% to minus 10% sequentially in the December quarter. Due to this sharp reduction in GAAP sales at the midpoint of the guidance, we are taking steps to reduce our manufacturing capacity, capital expenditures as well as expenses.

We are planning to reduce the clean room footprint in our Colorado 6-inch fab that we acquired with Atmel acquisition. At 6-inch wafer size, the fab is no longer competitive with other high volume 8-inch fab. Therefore we will be turning the 6-inch fab into a discrete and specialty fab doing silicon carbide field effect transistors, the transistors, MEMS and other discrete devices. We will be transferring high volume Atmel products from the 6-inch Colorado fab to our 8-inch fab in Arizona and Oregon. This transfer will take about 12 months to complete, largely because we brought up the highest volume process in 8-inch fabs for dual sourcing earlier.

In addition, we will be transferring some of the discrete products from Microsemi 4-inch fabs to the 6-inch fab in Colorado. These actions will create about $65 million in cost of good savings per year when completed. The first phase of this transfer will take about one year to complete and will achieve about two thirds of the savings. The balance of the transfers have a long tail and we'll take another two years after the first phase.

Regarding capital expenditures, we're reducing our CapEx for fiscal year 2020 to be between $90 million and $100 million for the year, a reduction of $25 million from our guidance on CapEx last quarter. Regarding the reduction OpEx, we're doing three things. Some of those are continuation of what we have been doing. First, we are approving new and replacement acquisitions very sparingly. Second, we will be managing discretionary spending very tightly. And third, our bonus program will yield a lower payout for the reduction in net sales.

For December quarter, we expect our non-GAAP gross margin to be between 61% and 61% of sales – gross margin to be between 61% and 61.4% of sales. We expect non-GAAP operating expenses to be between 26.2% and 28% of sales. We expect the non-

GAAP operating profit to be between 33% and 35.2% of sales. And we expect our non-GAAP earnings per share to be between $1.12 per share to $1.32 per share.

Given all the complications of accounting for acquisitions, including amortization of intangibles, restructuring charges and inventory write-up acquisitions, Microchip will continue to provide guidance and track its results on non-GAAP basis except for net sales which will be on a GAAP basis. We believe that non-GAAP results provide more meaningful comparison to prior quarters and we request that the analysts continue to report their non-GAAP estimates to first call.

With this operator, will you please poll for questions.

Question-and-Answer Session

Operator

Absolutely. [Operator Instructions] All right, we’ll take our first question from Chris Caso from Raymond James. Please go ahead.

Chris Caso

Yes. Thank you. Good evening. I guess the first question Steve, is the expectations for sell-in versus sell through in the December quarter. You already said that the distribution channel inventory is at a record low. So, is this guidance for December suggesting that that end demand is actually declining in December? Could you explain the difference there?

Steve Sanghi

The end demand is declining. There has been some destruction of end demand in various end-markets. So, automotive clearly where the number of units build in automotive are much lower in U.S., Europe, and China. The industrial market end demand has been weaker because of all the impact of tariffs and increased cost and similar thing we’re seeing in the home appliances market. So, yes, the end demand is weaker and sell-in we’re guiding down. We do not know what the net to distribution inventory will be in terms of increasing or decreasing, whether end-market demand will be higher than GAAP sales or lower slightly. But we think they could be roughly in the same range and could go either way.

Chris Caso

Right. Okay. As a follow-up then, maybe you can reconcile that with your comments of the potential of this inflection point. I guess what I understand you're saying is the opening backlog coming into the quarter was lower, but you're seeing stronger fill as you go through the quarter. How are you reconciling that better order fill with the prospect of end demand, perhaps a bit weaker?

Steve Sanghi

So, how we are reconciling it is the starting backlog in the quarter was significantly more weaker than minus 6% guidance at the midpoint, significantly weaker. So, some of that – fair amount of that has closed in the last five weeks because the curve of backlog fill is much deeper. And we are expecting that that kind of curve will continue and will end up really close to the guidance for providing, but where we end up would still be lower than the last quarter. It will require significantly more steeper curve to be even with the last quarter. So, we are expecting improvement because of steeper curve, but it doesn't get us to flat compare to last quarter.

Ganesh Moorthy

Yeah, and it probably is worth repeating what Steve has already said that our October 2019 bookings were the strongest month of bookings we've seen since June 2018.

Chris Caso

All Right. Thank you.

Steve Sanghi

For the kind of a lot of mixed messages, weaker backlog, but some inflection points and still leaves very hard to read in this environment. We said back in February that could be bottom, but it was very much tied to the trade settlement. We didn't get it. So, this time, we’re just being cautious and giving you all the puts and takes.

Chris Caso

Right. Got it. Thank you.

Operator

Thank you. Next, we’ll go with Gary Mobley from Wells Fargo Securities. Please go ahead.

Gary Mobley

Hey, guys, thanks for taking my question. You mentioned that sort of the retooling of your Colorado facility could bring on maybe a 50 basis point positive impact to gross margin long term. The near term looks like we’re contemplating the 100 basis point sequential decrease. How much of that degradation, the gross margin near term is due to underutilization and how much is due to mix?

Ganesh Moorthy

I can address that and Steve can add on to it. So, the quarter we just completed, we had underutilization charge are about $8.9 million. That charge will be higher in the December quarter. So, that is having an impact on gross margins that we’re seeing on a sequential basis. There’s always things like product mix that factor into it also. And then with demand down, it’s likely that we’ll have some accounting charges related to obsolescence doesn’t mean that the product isn’t good anymore, but we’ll have some obsolescence charges that will also impact the gross margins that we produce this quarter.

Gary Mobley

Okay. And just – I know it’s very, very early to call, but could you give us some sense of seasonal trends in the March quarter, based on past history and perhaps how you are feeling about the linearity bookings as we see here today?

Steve Sanghi

Well, seasonality is the hardest one to talk about, because of various acquisitions that we have completed. Prior to the Microsemi acquisition, for example, our end-market mix was dominated by industrial, automotive and consumer appliances. With the addition of Microsemi now, we have added three other significant end-markets, aerospace and defense, datacenter and communication where we had very little exposure. And last year, year or five quarters since we've had Microsemi, the environment hasn't been normal. A significant inventory correction in the last June and September of last year, and then subsequently, fighting through the U.S. China trade sanctions and all the other issues. So, we haven't really seen a combined company normal environment for a year or longer to be able to figure out what the seasonality with the current mix is.

So, I think that would be my answer that we – at the minus 6% of the midpoint, clearly that is below seasonal. We're not defending that it is seasonal. Prior to any of this acquisition, I think seasonality for December quarter used to be about minus 3 if I remember. We don't know where it is today.

Gary Mobley

All right. Thank you, guys.

Operator

Thank you. We'll next go with Vivek Arya from the Bank of America.

Vivek Arya

Thanks for taking my question. Steve, I was hoping you could help us understand the chronology here, because back in August, you gave some guidance, then in September, you kind of confirm the midpoint of that guidance. At that time, the hope was that September would be a normal month. And since then, the results are about, 11-ish million somewhat below. So, not bad, but somewhat below. And since that time, we have just heard such a wide range of views from here, you know one of your peers was very weak, but then most others have kind of been in line. And now, you're saying that October bookings are very strong but backlog is very weak. I think investors are just horribly confused as to what's really going on, what is driving such a week backlog and what is now driving the subtitle, what is causing all this?

Steve Sanghi

Vivek, in terms of confusion, join the party. I mean this has been a very, very confusing environment. On one hand, they've been fits and starts on the trade front, and the three largest of our markets which are industrial, automotive and consumer appliances heavily hit with large amount of tariffs and therefore they have a lot of demand destruction. In anytime you make any kind of guess with some resolution of the trade dispute, it really hasn't happened. And then you have had multitude of other issues with ZTE about a year ago then Huawei, you can ship is, not shipping then Hikvision and many other customers added. So, there has been a lot of confusion. And every company – I think if you look at the number a year-over-year, you will see that our performance year-over-year is pretty reasonable, but quarter-over-quarter, it just depends on when somebody went into inventory correction, how long the inventory correction lasted. We measured our September performance to the September performance of last year. However, September last year, we were still reporting numbers based on sell through revenue recognition as a non-GAAP. If you compare the numbers GAAP to GAAP, September quarter to September quarter, we were actually up, because last September quarter there was a substantial reduction in distribution inventory. I don't know if it's exactly correct.

Ganesh Moorthy

Yeah, we were not up but we had about an $80 million reduction last September in distribution inventory in that quarter.

Steve Sanghi

Yeah. So, as you compared to that, the number of get very confusing. So, in parallel with all these other confusions, last year, we also went through change of revenue recognition. So, I would say simply lay out the numbers for various companies and you will find that our year-over-year performance is better than the other large competitor you talked about.

Ganesh Moorthy

Vivek, in terms of chronology, the other thing to keep in mind is, if you remember, I think it was in early August, there were additional tariffs that were announced and were going to be taking place at various points in time. I think that creates more uncertainty in the market. And I think what happened was September ended up being a lot weaker as people were trying to sort out, customers are trying to sort out, what are they going to do. And that was reflected in distribution inventory going down, the overall results being less than what we had expected at the midpoint, and then beginning to reverse as we went into October, and then reflected in the guidance you're seeing today.

Vivek Arya

Got it. And my follow-up, Steve, how much do you think distributors will be willing to take down inventory that you mentioned, this is the lowest that you've seen in the last I think 15 years or so that you mentioned definitely far below historical trends. What are you hearing from them? I understand the uncertainty, but at some point, do you think you see the benefits of perhaps say DIB crunching from the distribution channel or is it too early to give a sense for – what does normalize distribution level look for you?

Steve Sanghi

I think the macro trends in the demand destruction by the tariffs and all this confusion created a much larger impacts than the other secular trends of impact of another competitors in distribution and distribution putting more focus on us. Those things happen over two, three years. And the effect of trade friction and all that is really much more immediate and much more severe. So, we've been telling you now for a few quarters that the distribution inventory went down, the sell through in several quarters now, I would say at least five quarters had been better than sell-in. And when would think with distribution inventory now, lowest in 15 years except one strange quarter in fiscal year '13. It wouldn't go down further, but we can't be sure of it. Distributors don't have confidence. The seeing the same issues we are seeing weakness in industrial market in automotive market and consumer appliance market, aerospace and defense and communications that kind of flattish, if distributors can manage their business, but even lower inventory they probably would.

Ganesh Moorthy

Right. They are going to leverage are generally short lead times to their advantage.

Steve Sanghi

Despite, reporting GAAP numbers based on selling you're very well aware of a stance. We manage a business to sell through and we do not go request any distributor to take any kind of inventory stock for shelves. So, we are focused on sell through and sell through is weak and therefore the selling is weak.

Vivek Arya

Thanks for the comment.

Operator

Thanks. We will be taking our next question from Harsh Kumar from the Piper Jaffray. Please go ahead.

Harsh Kumar

Yeah, thanks, Steve, for all the colors so far. I'm trying to square some of your comments. So, you're taking some steps in OpEx and CapEx, but October suggesting from your commentary some sort of an inflection point upward. So, should we just read into it as okay maybe we're not going to go down from the current guidance that you gave for December that sort of the new base should we look at and you're just adjusting your business to get out? I guess be more profitable and more cash flow and just optimize it a little bit or is it from the last can read into it?

Steve Sanghi

Well, I think what I'm reading into it is that we started the December quarter with much lower backlog on October 1 than it was in July 1. And you know if that had continued in the last five weeks, the guidance would be double digit negative. But we have made up significant gap by the fill being much stronger. And if that strength of that fill continues, then the results could be reasonably good. But there are also holidays coming, short month of November, short month of December, you know, Europe shuts off in the middle of December. So by all those puts and takes, our guess is that the December quarter still ends up about 6% lower than September quarter. And that minus 6% is a huge makeup from how low the backlog was in October one.

And then with the strength of the bookings, October was strong bookings, November so far looks like good strong bookings. If the bookings continue, then hopefully the January one backlog for the March quarter could be better than what we experienced as a backlog on October 1. And with continued strength of booking, hopefully, we have some sort of recovery, but I'm not really giving any guidance for March yet.

Harsh Kumar

Understood. Thanks for the color, Steve. And I think earlier you mentioned that the classic Microchip as you call your core business from some acquisition to go typically down about 3% in December. You think some of that and maybe the Chinese New Year stack kind of closer to Christmas this time has some effect on you know, some small portion of your consumer business, you think part of that's going on, perhaps impacting September and then coming back up in October?

Steve Sanghi

I think, you know, earlier gentleman asked that we gave guidance in early September that we reconfirmed our midpoint of our guidance. So kind of what happened, you know Ganesh mentioned and I mentioned also the month of September was quite weak. Weaker than what we expected causing us to miss a sales by about $10 million, $11 million. You know, the month of October was much stronger and November is continuing much stronger. So, you know, could it be because of some sort of light at the end of the tunnel on first phase of settlement with China, could be the inventory has gone low enough. You know, there are all these puts and takes and we really have put them all on the table, you know, the good points and bad points. And then we gave you a judgment and you could make your own judgment or agree or disagree with ours. That's where it is. Numbers are very hard to call in this uncertain environment.

Harsh Kumar

Understood, Steve. Thank you for the color.

Operator

Thank you. We are taking next Shawn Harrison from Longbow Research. Please go ahead.

Shawn Harrison

Hi, good afternoon. Thanks for taking my questions. I guess my first would be, is there any way to quantify, I know you've talked about it a lot so far, just how much September disappointed in terms of either the backlog or actual sales? Would you have been tracking toward the higher end of guidance, otherwise?

Steve Sanghi

No. I mean when we reconfirmed our guidance, we were essentially tracking towards the midpoint. And September was weak causing us to miss by 11 million, am I correct? Yeah.

Shawn Harrison

And that's the amount that we should consider what the shortfall was also and kind of general backlog as well?

Steve Sanghi

No, the backlog was much, much weaker.

Ganesh Moorthy

Remember backlog cross us over into the December quarter and exceeding quarters as well.

Steve Sanghi

And then you know earlier I mentioned that the backlog started on October 1, the backlog was down in double digits compared to July 1. And if we are giving minus 6% guidance now you know even if 4% change would be $52 million, right, on our revenue number. And the backlog on October 1 started much worse than minus 10, significantly worse than minus 10. So, we have made up a huge amount of gap with significantly steeper slope.

Shawn Harrison

Very helpful. And just as a follow-up...

Steve Sanghi

Today ruler on the slope and get to a number and tell you that's the number. Unfortunately we have seen that you know, when the backlog start so low, can be a steeper slope but then the slope can change and it could end early in the middle of December and not fill during the holidays. So you got account for all that and that's why I keep stressing that there are lots of puts and takes. And putting them all into consideration, we're giving you guidance that we believe is where we're headed.

Shawn Harrison

It's very helpful. Steve, if I may a follow-up. Just the incremental weakness you saw in the backlog, was it more on the analog side of the portfolio or the microcontroller side?

Steve Sanghi

It was largely pretty much across the board.

Ganesh Moorthy

There's no product specific backlog that was weaker than the other.

Shawn Harrison

Understood. Thank you.

Operator

Thank you. We're next going to William Stein from SunTrust. Please go ahead.

William Stein

Great. Thanks for taking my questions. Steve, you've already told us that the weakness was very broad based by markets and by geo. I wonder if the strength or the very recent strong recovery in bookings trends could be attributed to anything in particular, any geo, any end-market, any event.

Steve Sanghi

So, I would say, if you have to pick a geography that has shown strength, it would be China.

William Stein

But nothing by end-market there. We've heard about China auto recovering significantly. Are you seeing that as well?

Steve Sanghi

Yeah, I mean, you know, we manage our business by product lines as you know. So, you know, we have rough end-market commentary, where we believe that the only stronger end-market has been data centers, communication and aerospace and defense were flattish, and automotive industrial and consumer appliances were the weakest markets. You know with a one month booking in October, we can't really, you know, tell you a change in that tone. We just don't track it that way.

William Stein

Thanks. One more if I can. With regards to the Microsemi system, that ERP integrations that you're doing. Can you remind us of the timing to complete these? And I just forget whether there's a step function cost savings that happens at the end of it all? Or is it more linear as we go and remind us of the size of that, please? Thank you.

Ganesh Moorthy

So if you recall, we began this a year ago, and have had a number of transitions we make every quarter. We just did the most recent of that on November 1 of this year. In my prepared remarks, I said we have at least another four quarters to get substantially complete. We're about halfway through at this point in time. And the savings are more over time rather than a step function change. And as we get through enough of the systems, you know, we take the savings and that becomes a synergy that we add to what we've done.

Operator

All right, thank you. We're next going with Harlan Sur from JPMorgan.

Harlan Sur

Good afternoon. Thanks for taking my question. I know it's always tricky to reconcile SIA data with your results, but if I look at SIA data for calendar Q3, the overall general MCU market grew about 5% sequentially. But almost all of that growth came from 32-bit, while 8-bit decline, 16-bit was relatively flattish sequentially. You've grown the size of your 32-bit pretty strongly, but I think it's still about a third of your overall MCU business. So mix adjusted because you still have more 8-bit and 16-bit exposure. Is this the potential reason why your MCU business slightly underperformed the general industry in the September quarter?

Steve Sanghi

We have not analyzed the numbers again for SIA, so I'd rather not guess and make any comments. I think you know our – you mentioned end-market demand base microcontroller business was down 1.3%. I think many other results we have heard from various companies wouldn't lead us to believe that the business in September quarter was up 5%. I don't know how SIA comes up with the numbers, if you add up the numbers from TI and others, I don't know whether I can construct that number.

Ganesh Moorthy

Our 32-bit business is doing, you know, much stronger than 8-bit and 16-bit. I think these are businesses that are not as much 8-bit, 16-bit, 32-bit focused. They are broad market trends in automotive and industrial, in consumer appliances and they affect all segments of the microcontroller market.

Steve Sanghi

Our belief is in history that you know SIA, you know, especially during turbulent times like this, they revise the numbers and the significant changes reported and it's easily causes confusion like it's causing right now. If I look at, add up the results of most companies, they make microcontrollers, I don't really think I can get SIA numbers.

Harlan Sur

You know, that's a fair point. Okay. And then my follow-up, you know, you've been to a couple of quarters of cloud data centers spending digestion, but looks like spending is picking up back here in the second half of this year. It looks like you guys are seeing that as well. I think via the Microsemi acquisition, you guys have a relatively strong position in NVMe enterprise is the controllers, you've got a strong platform for PCIe switching products. And then you've got some of your core products right like secure MCUs and Ethernet products that go into the cloud as well. Roughly how big is cloud data center as an end-market for the team? I assume it's probably a bit easier to track given that these products are purpose designed for data center applications?

Ganesh Moorthy

So the product lines that address data center are more than just the Microsemi product line that came to data center. Clearly that is a big position that we have some of what you mentioned relative to these strength and storage. The strength in the SSDs and all that is good. I don't know if I have a good way to break out exactly what our data center. It's in the mid-teens is what my guess would be based on where we had seen the combined company, but that's from several quarters ago.

Steve Sanghi

We also have products into data center from the classic Microchip business prior to the Microsemi. And some of those products go into power supplies, they go into, you know, other IO control and various different areas. So, we had some data center exposure before, but obviously, the big one came in Microsemi.

Harlan Sur

Yeah. Okay, thank you.

Operator

Thank you very much for your question. [Operator Instruction] We'll take our next question from Mark Delaney from Goldman Sachs.

Mark Delaney

Yes, good afternoon. Thanks for taking the question. I'll give it to one. The October bookings strength that the company spoke to, are those primarily bookings that are for shipment in the December quarter, or are some of those bookings for shipping in the March quarter and maybe giving you a good start on your backlog for the March quarter? Thanks.

Steve Sanghi

Those bookings are aged every month from here on and into the future six, eight months out. So some are for December quarter, some are for March quarter, some of it even spill beyond the match quarter.

Operator

Thank you. We will take our next question from John Pitzer from Credit Suisse. Please go ahead.

John Pitzer

Yeah, good afternoon, guys. Thanks for taking my questions. Steve, to the entire December quarter, you've been pretty clear that your assumptions for terms are higher. I'm just kind of curious, given the strength you've seen quarter to date, from here on out, what's the expectations in terms of returns relative to trend? Do you expect – you need that steepness to continue to hit the midpoint or you embedding kind of a more normal turns in business in the second half of the quarter to hit the midpoint of guidance?

Steve Sanghi

So I'll speak qualitatively rather than quantitatively because we haven't disclosed what the backlog was, where it is now and all that. If the current slope of backlog fill continues, then the results will be very good. We're not expecting the slop to continue. So we in our judgment have moderated that slope, current slope. Some just because the backlog started very low and then people place the order, slope is high, as backlog starts to fill up, the slope will moderate. And the other is the effect of holidays, because you know, you don't do a lot of bookings over the Thanksgiving week. And then December, Europe is weak as usually, U.S. is second and then you know, Asia usually continues to work over the holidays. So we have based on our experience from our history, we have model that in. But I will admit that we have moderated that slope because we think the slope is not sustainable.

Eric Bjornholt

I think I'll also point out that we've given broad range of guidance.

Steve Sanghi

And we have given a pretty broad range of guidance to account for all those puts and takes.

Operator

Thank you. We're taking our next question from Chris Danely from Citigroup.

Christopher Danely

Hey, thanks, guys. I'll try to stick to one question. Steve, is this I guess, sluggish type of environment continues into the March quarter. Theoretically, what would you be looking to do as far as OpEx goes in your own inventory?

Steve Sanghi

Well, if the sluggish environment were to continue, the OpEx would be basically in the range. We will keep on you know, controlling any headcount additions, sparingly approve any replacement acquisitions. Bonus will continue to be lower, you know, then the target type of bonuses. You know, CapEx will, you know, continue to tighten, because if there's no growth, we will need capacity. And a lot of the capital we're investing is just incremental here and there is no big capital needed for growth in this environment. So, you know, those are the things we would do if the environment continues to be sluggish. If the environment were to accelerate, you know, I would think we still have sufficient capacity and sufficient inventory to ship the upside. So you wouldn't see a growth in, you know, CapEx immediately and you wouldn't see growth in expenses either. So if the upside in revenue were to come through, I think there will be a pretty good leverage for the earnings to go to the bottom.

Christopher Danely

Great. Thanks, guys.

Operator

Thank you. We'll next go with Vijay Rakesh from Mizuho Group. Please go ahead.

Vijay Rakesh

Thanks. Just Steve and Eric, just briefly – you talked about inventory has come down quite a bit. I was just wondering if the visibility extended to the end customer also, have you seen the end customers stock up ahead of the tariffs or you think inventories going out to the end customers have come down as well?

Ganesh Moorthy

You know, we really have no meaningful visibility into end customers and what they're doing with their inventory. They don't report to us. We don't see the change from week to week as we do in the case of distribution. So you know, they are – we presume doing what they think is the right thing for their business. But we have no color one way or the other.

Vijay Rakesh

Got it. And I know you mentioned October you saw a nice snapback or a pickup in backlog most different China. Given the – Steve mentioned auto and industrial where the weakest, would expect those to snap back faster than others if we see some rebounder? That's it.

Thanks.

Steve Sanghi

So it's really hard to call future by end-markets. It's easier to talk about the past. Yeah, if there's some sort of trade settlement, there was to be clear rules were overnight to another tweet, you know, the duties will not go higher or something then you would see some stability and return to normalcy on the industrial market and appliance market. Automotive, there is a settlement with GM and GM know, and so you should see some impact there. So I think those are the things that would show strength. Yes.

Vijay Rakesh

Got it. Thanks.

Operator

We'll next go with Christopher Rolland from Susquehanna International Group.

Christopher Rolland

Thanks for the question. Steve, thanks for all this big picture stuff. In your experience, maybe you can talk about how this cycle has been different from prior ones. You know, kind of what most surprised you this time around? And then how do you feel about this being a more of a semiconductor specific driven cycle versus you know, an economic cycle? And do you have any thoughts on an economic cycle, given how long this economic cycle has lasted?

Steve Sanghi

Well, that's a tough ball that you have served. You know I'm not an economist and that's not my field. So I'll give you some feel for really, you know how I'm thinking. Many of the cycles our industry has seen are the cycles created by our own industry through lonely times, excessive inventory build, and then the bubble bursting and going the other way and company shipping below demand for a while and then the cycle correcting. So those are, you know, semiconductor industry and its customer cause cycles by successively under shipping demand and over shipping demand. This cycle hasn't been caused by the industry. This cycle has been caused by the much larger economic forces. And if I were to name a single one, it will be the U.S. China trade. It's really been caused by that.

I tried to explain it before and let me take another shot at it. The world economy runs on manufactures building the product and putting into the inventory with a forecast that the customers will come and buy that product. Now given an example of a grocery store, or an electronic store, you can go into the stores, there is lots of inventory and you can come out with bags full of your grocery. You do not order your grocery a week ahead of time and then go pick up the delivery. In fact, if you were to go into the grocery store which you want, it isn't there, you will go to another store and buy it.

So, world economies are largely run on inventory. Now, enter the tariff uncertainty, imagine a customer building the product in China and let's say there were no tariffs on it and bringing it to U.S. – I'm sorry – they were tariffs on it, there is 25% tariff format. So, they bring the product to U.S. with 25% tariff on it and having then the uncertainty to be able to pass on that tariff to the end customer. They don't know whether they can or they can't. And the second risk is to bring the inventory to U.S. and then there is settlement announced. Once a settlement is announced, no end customer will pay the 25% tariff, because the manufacturer brought it here with tariff at their own risk. So, what it does is it makes everybody stop in their tracks. They cut down the inventory on the loading dock to the manufacturing lines, to the raw material, to the finished goods, to the transportation hubs everywhere, people draw down the inventory, because they do not know what the landed cost is and what they can pass to their customers. That is the impact we have seen in many, many of the market. And when there is the clarity on the tariff front, then you will see the rebuilding of that supply chain inventory, which would have a very positive effect on us.

Christopher Rolland

Got it. Thank you for that extra insight. Very helpful. Yeah, that's great. Thank you, Steve.

Operator

Thank you. We're going next with Gil Alexandre from the Darphil Associates. Please go ahead.

Gilbert Alexandre

Good evening. I assume as you look at your long term models that you still have gross margins at 63% and operating margins at 40.5%, once we get over these problems?

Steve Sanghi

Yes, Gil. We have not changed a longer term model. In fact, the changes we announced today on the restructuring of our Colorado fab and bringing some of those 6-inch products to our higher volume 8-inch fabs and really creating $65 million in savings and the process. What we have done is we have lowered the revenue at which we achieve our target model. So, prior to that, it required a certain amount of revenue to fill up our factories and remove the underutilization to achieve a 63% target margin. By making those changes we are not galvanized for you how much, but we have lowered the revenue we need to achieve to achieve the target margin because we're taking so much cost out of the system.

Gilbert Alexandre

Thank you. May I just ask one question on China and you can skip it.

Steve Sanghi

Go ahead.

Gilbert Alexandre

You talk of this 25% tariff. Have you seen any talk that they may – that people want to reduce that tariff or is that all open ended?

Steve Sanghi

You have some information you are sharing.

Ganesh Moorthy

Are you talking about the trade discussion between the U.S. and China? Because I think that is that the entire point is going to be, the 25% tariff is creating uncertainty on both sides of the ocean, is creating uncertainty in other regions of the world as well.

Steve Sanghi

In phase one settlement that has been touted by the administration, the 25% tariff doesn't go away. They only agreed to not increase the tariff from 25 to 30, but there is some talk whether it's in phase two or gets done in phase one with certain $100 billion worth of goods, the tariff will go down, but those are just talk so far?

Ganesh Moorthy

I think we see different news reports. We don't have any direct insight into the discussions and decisions. I think there is a, in good faith effort to try to deescalate from where we are, and it may take more than one phase, but the rate at which that comes down and the time when it impacts, the products that we are designed into, our customers are impacted by is unclear to us.

Even if there is a settlement, which creates a finality, the tariffs are not zero, tariffs are some number 10%, 15%, but they are constant and it's not going to be another tweet which is going to increase those tariffs. Once the customers, distributors, contract manufacturers, everybody has that finality and they can run the business in a normal way and the inventories will get replenished. It is the uncertainty which causes it because they don't know what the landed cost will be.

Gilbert Alexandre

I want to thank you. Good luck.

Steve Sanghi

Thank you, Gil. Anything else, Operator?

Operator

We'll take our next question from Craig Ellis from B. Riley FBR.

Carlin Lynch

Hey guys, this is Carlin Lynch on for Craig. Just wanted to ask a question on the cross selling opportunities with Microsemi. I think last quarter, you had said that the muted environment had kind of slow down some of that progress. If we were to get to a normalized environment next year, could we see those cross selling opportunities kind of springboard? Is the design activity going on and or just seeing muted demand everywhere, or any kind of qualitative color you could give on the cross selling opportunities would be great?

Ganesh Moorthy

So, as you note, the cross selling opportunities are all at the design in stage. So, these are platforms that get designed and then go to production over 18, 24 months of time. The design in activity is going extremely well. And across the board, the combined sales teams, combined business unit teams of Microchip are all highly focused on enabling that a new design. The environment today is really for products of design back in time. And that muted environment doesn't change. But the seeds are being planted, new designs and the increased total system solutions were able to address are clearly will pay off in time as the current – as the new designs go to production in, 12, 18, 24 months of time.

Carlin Lynch

So, just if I could clarify there. So we would expect some of that cross selling opportunity to start to manifest next year, even if the demand environment kind of just skips along the bottom here?

Steve Sanghi

Yeah, and you got to take it over time, if this is not a single application, single customer that drives in one way or another. There's hundreds of applications customers over which this would happen. But clearly there is a multiplier that comes from cross selling from selling a more complete solution to the customer. And as that ramps in, I don't know if it is exactly first half of next year, second half, but in time, as the environment improves, these new designs go to production, we will see the benefits that come from it.

Carlin Lynch

All right. Thanks, guys.

Operator

Thank you. We're going next to Craig Hettenbach from Morgan Stanley.

Craig Hettenbach

Question for Steve. One of the secondary impacts of the trade war is just the acceleration of China to try to move to more of a localization effort. Can you talk about just maybe parts of your portfolio where you see maybe some overlap to that versus other parts that you think, a lot more immune to what China might be trying to do from a development perspective?

Steve Sanghi

So, we hear a lot of talk and we don't see a lot of action on that front. There may be action on certain product lines, I think they're really maybe trying to build processes and graphic processes and others, we do not really see that can impact today on our data center products, on our FPGA products, on our discrete and other products, our microcontroller analog, we hear a lot of talk about it. In longer term, there could be an issue where they want to either design their own product or not prefer to design with Americans. I think in a short period of time, less than a year of this trade war, you can't really design a massive portfolio that microchip has to make a meaningful impact on it. So, we really not seeing that on revenue today, but we seeing it in sentiment.

Ganesh Moorthy

And I would add to it, the threat from local suppliers in China is nothing new. It's been there for many years. It's a question of do they have the types of products, the quality of the product, the capability to support the designs, the wide range of applications and customers that you need to be able to serve with it. You know, that is a very large task.

And they may be more environment today that says, you know, you should consider more of a local supplier, but the task is very, very large for anybody who wants to do it. And if they could, they would have been doing it for several years before.

Craig Hettenbach

Got it. Thanks.

Operator

Thank you. We're going to Vivek Arya with Bank of America.

Vivek Arya

Thanks for the very quick follow-up. Actually I wonder those same lines in terms of competition and substitution. Steve, have you seen any design shifts to your – perhaps your European or Japanese competitors who have been in the market for a longer period of time? You know, does that become a factor going forward?

Steve Sanghi

You know, like I said, first we have a very, very broad customer base, we serve over 120,000 plus customers. So it's very, very hard to track. We're not seeing any preponderance of evidence to see there is any design shift. We're hitting in sentiment, the so called non-sentiment, you may have, you know, heard that kind of language where, you know, government is saying, you know, design with Chinese customers first, design with Taiwanese or Asian is second, you know, design with the Europeans third, and Americans the last. But you know, 95%, 97% of products we build at all proprietary nature with no pin compatible part available. So in a short period of time, we really haven't seen any of that shift.

The shift will first become visible at the design stage if it does, and I don't think we have strong evidence today that that's happening. We're not losing designs like crazy. Our funnel size is still very, very large. And we're able to leverage a lot of our more commodity like products with more advanced products, but the total system solution if they're on the same board.

Vivek Arya

Thank you.

Steve Sanghi

This cause for concern and we're watching and we are making the product better, finding other sales mechanisms to bundle it and all that. So negative sentiment in China is definitely there, but it's not really, you know, being seen in bookings and revenue dollars today.

Operator

Thank you. It appears that there are no further questions at this time. Mr. Sanghi, I'd like to turn the conference back to you for any additional or closing remarks.

Steve Sanghi

Well, I want to thank everyone. This has been a difficult year with all the uncertainty. Please continue to bear with us and we'll see some of you on the road as we go to various conferences. Thank you very much.

Operator

This concludes today's call. Thank you for your participation. You may now go ahead and disconnect.