

Dialog-Semiconductor-12-11-19

Jose Cano:

Good afternoon and thanks to everyone for joining us on such short notice. As usual, I need to remind everyone that today's briefing and some of the answers to your questions may contain forward looking statements. These statements reflect management's current views and there are risks associated with them.

You can find a full explanation of these risks on page two of the slides we published last night, also available on our website. I will now hand over to Jalal, who will open the call with some initial remarks. Jalal, over to you.

Jalal Bagherli:

Thank you, Jose. And good afternoon to everyone. Thank you for joining us on today's call, where Wissam and I will share an update on Dialog Semiconductor's long-term financial model. I will give a short overview of where we are with our strategy and where we see the business going. Before handing over to Wissam, I will go into the new financial model in more detail. We will take any questions you have at the end.

We recently completed a strategic review of our business, looking ahead to the next three, four years. The updated outlook supports our belief that the business will see meaningful improvement in both underlying gross margin and operating margin. This improvement is the result of extending our power efficient mixed signal product portfolio in diverse markets of IoT, industrial, automotive, and computing; the acceleration of ASSP products' revenue; alongside further savings in manufacturing and operational costs. Dialog's growth strategy is focused on fast growing segments of the IoT, mobile, industrial, automotive, and computing markets, where the company sees significant opportunities to drive its high performing mixed signal IC leadership.

I'd like to reiterate our confidence in the successful execution of our growth strategy. We are on track to deliver the growth ambition we laid out at the 2018 Capital Markets Day. As we demonstrated last week, all our growth vectors remain in place. So far, we've made excellent progress towards our revenue targets of mid-teens percentage growth in the period 2018 to 2022. In the first nine months of this year, we have been awarded designs for mixed signal custom products with a lifetime revenue, which we estimate at approximately \$1 billion. We are gradually changing the shape of our business, adding more power-efficient mixed signal products to our portfolio, diversifying our customer base, and broadening our end-market exposure. This combined with savings in manufacturing costs has enabled us to improve our gross margin gradually and continually over the last three years.

With a set of plans already in place, we believe we will be able to continue this trend driven by: focusing on high value products combined with operational excellence, both at the product development level and in the manufacturing process; and shifting our portfolio towards a greater share of ASSP standard products over the course of the next three years, increasing it organically from 30 percent to approximately 60 percent by 2022. To conclude, the building -- we're building on our strong heritage in IoT and mobile and leveraging over 30 years of mixed signal expertise and world class power efficient IP to create long term shareholder value, we are successfully expanding Dialog's product portfolio to meet a range of exciting opportunities in new markets. And we believe that this upgraded financial model best represents the direction in which the company is going. Finally, we remain committed to

maintaining disciplined capital allocation while investing in our growth strategy and returning cash to shareholders through share buybacks. On that note, I'd like to hand over now to Wissam.

Wissam Jabre:

Thanks, Jalal. Good afternoon, everyone, and thank you for joining us today. As Jalal just said, the business performance and development is consistently demonstrating that our growth strategy is on track. And so, today, I will be taking you through our updated long-term underlying financial targets. Building on the strength of our long-term growth drivers, we are well positioned to benefit from exciting opportunities in our target end-markets. We continue to see revenue growth of mid-teens percentage points for the unaffected business, which excludes the legacy revenue from the licensed business. As a result of our evolving high-performance product base and revenue mix, together with manufacturing cost savings and operational improvements, we now expect an underlying gross margin range of 50 to 53 percent. Significantly, up from the 47 to 48 percent we communicated in November 2018.

Our top priority is to grow the revenue, so we will continue to make focused and targeted R&D investments. Therefore, we anticipate underlying R&D expenses to be in the range of 18 to 20 percent of revenue, which is slightly higher than the previous range. Underlying SG&A will remain at 8 to 10 percent of revenue as we focus on expanding our global sales and distribution channels while maintaining G&A costs at an optimal level. As a result of the strong business execution and continuous underlying gross margin expansion, we are now targeting increased underlying operating margin of 20 to 25 percent previously at 18 to 23 percent. The group underlying effective tax rate is expected to be at approximately 19 to 20 percent. As Jalal highlighted, we remain committed to a disciplined capital allocation. We have ample financial flexibility to pursue our growth strategy, including value enhancing M&A, while maintaining a healthy balance sheet and consistent return of capital to shareholders through share buybacks.

Our strong balance sheet and cash flow generation allow us to take advantage of opportunities in a consolidating industry that enhance our competitive positioning in our target and markets. As you may have seen on the slides, we published this morning, over the past three years, we have invested \$1.5 billion in growing the business of which \$354 million were assigned to inorganic growth. During the same period, we returned \$292 million to our shareholders through the share buyback program. To conclude, the solid performance of our business and successful execution of our growth strategy, give us confidence in the future prospects of the company. Jalal and I will now take any questions you have about today's update. Jordan, please open the line for questions.

Operator:

Thank you. Ladies and gentlemen, if you'd like to ask a question, please press star followed by one on your telephone keypad now. If you change your mind, please press star followed by two. And when preparing to ask your question, please ensure your phone is muted locally. Our first question comes from Achal Sultania of Credit Suisse. Achal, please go ahead.

Achal Sultania:

Hi, good afternoon Jalal and Wissam. Just a question on the gross margin. So, that the three-percentage point increase -- or actually four and a half if you look at the midpoint. Is it fair to say that a majority of that is being driven by the Apple accounting treatment? You're

basically putting \$6 million as in -- as a revenue, licensing revenue every quarter. That probably translates to one and a half, two percentage points of gross margin improvement and the rest a couple of percentage points improvement is coming from product mix. Is that a fair way to look at this guidance upgrade on gross margin?

Wissam Jabre:

Yeah, hi Achal. Good afternoon. Thanks for the question. In fact, when -- so when you look at the accounting treatment that I believe you're referring to, the license revenue. If we normalize for the license revenue for 2019, for instance, the impact is around 50 to 60 basis points. And so, going forward, you know, I would expect that impact to potentially be anywhere between 100 and 140 basis points. And so, it doesn't account for the majority of the margin expansion it accounts for a portion of it. The majority of the expansion is primarily driven by a -- what we see as a favorable product mix shift, as well as obviously the manufacturing cost improvements as well as other operational improvements.

Achal Sultania:

Okay. Thanks, Wissam. And maybe just a follow up on that product mix. Is it fair to assume that the sub-PMIC business and in the main Apple PMIC business that you're doing is probably similar kind of gross margin? So, then most of the improvement is coming from the rest of the areas. Which is Bluetooth and advance mixed signals.

Jalal Bagherli:

Yeah so, I think, you know, there's three things we mentioned. So, it's probably worth just recapping. So, your assumption is correct. The -- I mean, not every product is 100 percent the same in the custom parts, but they're broadly similar margins, both new and the legacy. But you know, as we shift to business more as a percentage ratio for the ASSPs and standard products, those carry a higher margin. And that includes the Bluetooth, that does include the CMIC business, that includes backlighting. It does include automotive infotainment PMICs we're doing, and also audio products. So, all higher -- on much higher margins than our, you know, custom business. So, that's one part. The second aspect is many of our new products are targeting outside mobile. So, we're going after automotive, industrial, IoT, and they tend to carry higher margin than very high volume, very price sensitive mobile market. So, that's the reason for seeing a better margin. But this shift is happening over a three-year period. This is why we're seeing the gradual and continual change and we have demonstrated that in the last three years, by the way. So, this will continue over the next three years.

Achal Sultania:

Thanks Jalal and Wissam. Thank you.

Jalal Bagherli:

You're welcome.

Operator:

Our next question comes from Andrew Gardiner of Barclays. Andrew, please go ahead.

Andrew Gardiner:

Good afternoon, guys, thanks for taking the question. I just had one on timing. When you first laid out your target, the long-term target operating model this time last year it was with a view from 2018 out to 2022. Is that indeed still the same for these revised targets? Should

we think of you getting into these kind of margin ranges or relative, sort of, rep intensity ranges in the 21, 22 timeframe?

Jalal Bagherli:

So, I think we -- over the years, we've discussed broadly the same and it haven't changed. But, you know, again, I want to emphasize you're talking about gradual improvements. So, I don't think anybody should model or should expect that there would be a step function change in the numbers from today to the ones we're projecting. But, you know, as you've seen it in our debate, we've increased our gross margin over the last three years as I said earlier, it's a continual step improvement. But this ratio of the mix change happens between now and 2022. So, it's fair to assume that this will be, you know, that if you let me get closer to this model every year that passes because, you know, the ratio changes more towards ASSP and away from mobile.

Andrew Gardiner:

Thank you.

Operator:

As a reminder, that's star followed by one or the flag icon if you're joining online for further questions. Our next question comes from David O'Connor of Exane BNP Paribas. David, please go ahead.

David O'Connor:

Great. Thanks for taking my question. Maybe one or two from her, from my side on firstly, the mid-team revenue CAGR. Can you give us an idea how much of this is attributed to auto industrial IoT versus mobile -- yeah, versus how much of that is driven by mobile? That's my first question.

Jalal Bagherli:

I don't think we've you know, we've changed the model that we showed, you know, last time, which is, you know, you said if you remember our famous color charts, the growth business did some with Apple. We had a CAGR for that, and that's all mostly mobile. And then the blue, which was the non -- you know, Apple business, it was it was all IoT, auto industrial, and consumer other areas non-mobile? So, that remains the same. And that was in, you know, the 10 to 15 percent range we indicated.

David O'Connor:

Okay. About the mid-teens CAGR from the from the model. How back-end is that in terms of the ramp up?

Jalal Bagherli:

Well there are a lot of products. I just listed, four or five different product lines, that have different profiles. So, we've seen quite a lot of growth in the sub-PMICs this year, right, in 2019. So, you're probably not going to get 100 percent growth every year. So, that'll slow down, but it'll still be significant growth, particularly in 2021 when the next wave of brand-new products kick-in, which we indicated in our quarterly release. In the other ones, I think you can fairly -- model it fairly linearly for the IoT and industrial and automotive. And these are Bluetooth and this is infotainment, this is the CMICs, and this is the backlight display drivers. So, you know, they're not going to be following exact same profile. But if you

aggregate those, I think the group -- you know, the aggregated growth that year would be -- it would be similar a year going forward.

David O'Conor:

Okay, got it. And maybe one follow-up for Wissam. You've increased the revenue [unintelligible] to the R&D CAGR but no change on the revenue side. Just wondering, where did you see that additional investment on the R&D side of things? Thanks.

Wissam Jabre:

David, the -- when you look at our R&D over the last few years, we've been running at around the 20 percent mark, and we're targeting now 18 to 20 percent because we see revenue growth as our top priority. And so, typically, there is roughly speaking around a couple of years of lag between the R&D investment and the revenue growth and the way it happens. And so, the expectation is we want to continue to drive these mid-teens growth beyond our planning horizon. And so, that's why we feel like the intensity or percent of revenue as 18 to 20 percent is the more appropriate target for us to do to go after. And also, when you look at the product portfolio and we're aiming to shift the portfolio, that requires us to put a bit more investments and so to enable us to drive these higher gross margins as well.

David O'Conor:

Understood. Thank you.

Wissam Jabre:

You're welcome.

Operator:

Our next question comes from, Adithya Metuku of Bank of America. Adithya, please go ahead.

Adithya Metuku

Good afternoon, guys. One question really, when you're giving these targets out for 22, 23, I just wanted to understand how much visibility you have on the top line, especially with your average business. Any color you could provide there would be much appreciated. Thank you.

Jalal Bagherli:

Hi, Adi. You know, I think we have as much visibility as, you know, all other kinds of companies, really. Actually, the business with our largest customer is probably got the highest visibility, I would say, because there are custom designs that we have to work on and, you know, they take years for completing the custom design and then qualification by customers. So, we have more visibility on those than general market growth in, you know, any of the standard products by definition, because, you know, we don't know three years from now who's going to adopt Bluetooth for the next toothbrush. And there's a lot of customers, so that there's a fragmentation in this kind of mass market. Whereas a custom business, we have a lot more visibility. On the earnings release, I indicated that the businesses we want for custom since this beginning of the year now approach a revenue value of about \$1 billion in their lifetime. So, many of those that's we won in Q3, for example, only start going to production in 2021. So, that means we have good visibility of those. And of course, for 2022 when they become full production for a full year. So, hopefully that answers your question.

Adithya Metuku

But if you were to compare the visibility you have today to when you last issued targets about three, four years ago, would you say it's very different, especially the largest customer?

Jalal Bagherli:

Yes, I think -- you know, remember that 2018 the Capital Market day we had just concluded the deal with Apple. You know, we had agreements on how we would work together going forward and in good, good faith and good trust. This is now a year later, and we have definitive designs that we've been working on from beginning of the year and also the bunch of designs that we won in Q3, so it's a lot more definitive. And also, the time period is now a year less, right, since 2018. We were projecting for 2022. Now, it's one year less and we have much better visibility. So, overall, I think, you know, if I had, I don't know, 60 percent confidence, then I have more like 85 percent confidence now.

Adithya Metuku

Ok, thank you.

Operator:

As a final reminder, that star followed by one for any further questions. Next question comes from Harald Schnitzer of DZ Bank. Harald, please go ahead.

Harald Schnitzer:

Thank you, could you -- could you remind us, please, how long was the contract with everyone on the PMIC side, on the sub-PMIC side?

Jalal Bagherli:

The sub-PMIC or the main PMIC?

Harald Schnitzer:

The sub-PMIC

Jalal Bagherli:

Okay, so not sure what you mean by contract, but we are basically continually working on new awards of sub-PMICs and each one when we win it, it is one year from completion. Sometimes less, but usually they go to production about 18 months, two years after we get that award. And then the remaining production for something like three years. So, we have, you know, we have -- I'm not sure if I answered your question, but, you know, so we got good visibility for finance of this model for 2020.

Harald Schnitzer:

Thank you.

Operator:

We have no further questions on the line. So, I'll hand it back.

Jose Cano:

Oh, thank you, Jordan. I just want to say thank you to everyone again for joining us. And as always, if you have any questions, please don't hesitate to reach out. Thank you very much.

[end of transcript]