Ultra Clean Holdings, Inc. [UCTT]
Q4 2018 Earnings Call & Webcast
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Company Participants:
Rhonda Bennetto; Vice President, Investor Relations
Jim Scholhamer; Chief Executive Officer
Sheri Savage; Chief Financial Officer

Analyst Participants:
Quinn Bolton; Needham & Company
Karl Ackerman; Cowen and Company
Patrick Ho; Stifel Nicolaus
David Dooley; Steelhead Securities

Presentation:

Operator: Good day, everyone, and welcome to the Ultra Clean Technologies Fourth-Quarter and Full-Year 2018 earnings conference call. [Operator Instructions] Please note that today's event is being recorded.

I would now like to turn the conference over to Rhonda Bennetto, Investor Relations. Please go ahead.

Rhonda Bennetto: Thank you, Operator. Good afternoon, everyone, and thank you for joining us. With me are Jim Scholhamer, Chief Executive Officer, and Sheri Savage, Chief Financial Officer. Jim will begin with some prepared remarks about the business, and Sheri will follow with the financial review. Then we'll open up the call for questions.

The press release we issued earlier this afternoon, along with the information about the webcast and how to access a replay of this call, can be found on the Investor Relations section of our website, at www.uct.com.

Today's call contains forward-looking statements. Investors are cautioned that these statements involve risks and uncertainties that may cause actual results to differ materially from those discussed on this call. Information concerning these risks and uncertainties is contained in our periodic filings with the SEC, including our most recent Form 10-Q and 10-K and in the press release relating to today's call. All forward-looking statements are based on management's estimates, projections and assumptions as of today, and UCT assumes no obligation to update them after today's call.

Also on today's call we will be referring to non-GAAP adjusted financial measures, and reconciliations to GAAP can be found in today's press release.

And with that, I'd like to turn the call over to Jim. Jim?

Jim Scholhamer: Thank you, Rhonda, and good afternoon, everyone. Thank you for joining us for our fourth-quarter and full-year 2018 conference call and webcast.

First, I'm going to highlight a few financial results that Sheri will expand on in her commentary. I'll follow this with an overview of how we see the short- and long-term semiconductor market landscape and outlook and conclude by outlining some deliberate actions we are taking to become more profitable and increase the value we deliver to our customers and our shareholders.

With the addition of Quantum's first full quarter of revenue we were able to post top-line results for the fourth quarter of just over $257 million, at the high end of our guided range. These results capped off a strong year for us, with 18.6% revenue growth year over year despite an uncertain and dynamic second half. Acquiring Quantum has proven to be an extremely valuable contributor to UCT and the diversified and complementary capabilities have already begun to transform our financial profile. In the fourth quarter UCT's non-GAAP gross margin improved 300 points over the third quarter. Operating margin improved slightly from 6.4% to 6.5% quarter over quarter, indicating there is work to be done, and I'll expand on exactly how we plan to accelerate our profitability in a moment.

First, I'd like to talk about the semiconductor landscape in general and describe what we are seeing from our position in the value chain, both short and longer term. Then I'll describe what we are doing to offset industry uncertainty by elaborating on cost improvements we are undertaking to rightsize our business.

I'll start with the IDMs, where our service business plays a significant role. The semiconductor business is defined by rapid technological changes and the need to maintain high levels of investment for new materials and innovative manufacturing processes for increasingly complex chip design. Last year IDMs admitted they did not perceive the magnitude of the economic deceleration in the second half of 2018, especially in China, resulting in IDMs posting year-end results well below expectations.

Intensifying competition in the smartphone business, mounting macro uncertainties and lackluster demand for memory chips were cited as the primary reasons for the slowdown and have resulted in a softer outlook for 2019. Despite this, Quantum holds a very distinct competitive advantage and is expected to grow mid-to-high single digits in 2019, even though wafer fab equipment spending is expected to decline. We benefit in two distinct ways. First, we receive a recurring revenue stream from our ongoing service within the growing install base, where we hold a leading position. Second, we work with our top-tier IDM customers as they invest in new fabs requiring highly technical cleaning and analytical solutions. We add value by partnering closely with our customers, helping them extract increased technical capability and higher productivity from existing and new assets with its advanced products. As wafer starts increase, so does our service business. This gives us great confidence in our ability to sustain stronger performance than our peers, who rely solely on WFE spend.

Taking a step down the value chain, OEMs are struggling with the trickledown effect from the push-outs announced by the IDMs. Industry fundamentals, especially within the memory segment, are showing weakness as both NAND and DRAM spending continues to contract, resulting in excess inventory in this business. We anticipate these elevated inventory levels to normalize over the next few quarters, which bodes well for a more favorable 2020. Non-memory sentiment is slightly more optimistic and is predicted by some to grow in 2019, albeit slightly. Regardless of these near-term headwinds, industry investment remains rational and disciplined and poised to deliver a very attractive long-term growth opportunity.

And that brings us to our product and solutions business. UCT delivers highly integrated, one-stop, end-to-end solutions for our OEM customers. Unlike the majority of Quantum's business with the IDMs, UCT's custom manufacturing offerings are driven primarily by WFE capital equipment spend. Our direct visibility, based on customers' orders, is limited and can change significantly, even within a quarter.

Based on what we've seen and heard so far this year from IDMs and OEMs, together with our internal marketing intelligence, the industry is taking a much more muted tone and we believe we could see weakness continue throughout the year. While we hope that we are wrong and a recovery does materialize in the second half of this year, we are restructuring our business now to be more profitable in either scenario.

With that summary as a backdrop, we felt it was imperative to initiate a series of rigorous cost improvement initiatives to increase profitability without compromising or constraining our capacity to react quickly when industry growth resumes. While we did reduce expenses in the second half of last year as the equipment market softened, they were not sufficient to take us through what we now believe is an extended period of reduced demand.

Our products and solutions business and our service business are designed to drive operational excellence companywide. Both underwent an exhaustive analysis and brought forward a list of objectives that they must meet to improve profitability and drive higher returns for our shareholders over the longer term. Our restructuring plan includes consolidating and eliminating sites, moving additional production to Asia, the elimination or postponement of certain planned capital expenditures and a meaningful reduction in workforce.

While some of these initiatives are underway, others will be rolled out over the coming quarters. We anticipate cost improvements along the way. However, the majority will be realized in the second half of the year. Expected annualized cost savings from the restructuring plan will be in the $15 million to $20 million range once completed.

UCT has successfully managed through several industry cycles, as recently as late as 2016, and has emerged a much stronger company than when those disruptions began. We are working very closely with our customers to position us for significant growth when the industry rebounds.

As we navigate these short-term uncertainties, we are confident that we will be in a much stronger position to benefit from the multiyear technology inflections in leading-edge logic, foundry and memory, as well as the increased requirements in semis more broadly. The semiconductor industry is set to benefit from ongoing next-generation innovation and development in home and industrial automation systems, wearable devices, advanced software, data centers, cloud computing, internet-connected devices and artificial intelligence, just to name a few. Increasing consumption of electronic components in our ever-expanding automated and connected world will further contribute to growth in the industry.

For comparative purposes our non-semi business was approximately 7% of total revenue in the fourth quarter, of which display made up roughly half. We are seeing display investment timing delays resulting from a softer market outlook. Although we believe spending in display equipment will remain muted over a longer period, the display market remains [a key link] as technology transitions accelerate, creating meaningful opportunities during the coming years.

In summary, we are very confident in the long-term prospects of the semiconductor industry, with ever-increasing applications. We view the current downturn as an opportunity to materially improve our bottom line while ensuring that we protect our revenue and optimize our capabilities to secure long-term growth. I would like to thank our employees and our shareholders for their continued support and I look forward to updating you on our next call.

With that, I'll turn the call over to Sheri.

Sheri Savage: Thanks, Jim, and good afternoon, everyone. Thanks for joining us.

In today's discussion I will be referring to non-GAAP numbers only. I'll begin with a short recap of 2018, then dive into our fourth-quarter results.

For the full year of 2018, total revenue was $1.1 billion, an increase of 18.6% over the prior year. Gross margin averaged 16.5% compared to 18.1% in 2017. Operating expenses as a percentage of revenue increased by less than 1% over the prior period, totaling $94.9 million. Operating margin came in at 7.8% compared with 10.3% in the prior year. Diluted earnings per share were $1.66 on net income of $64.7 million compared to $2.34 and $80.3 million in 2017. And lastly for the full year, we generated cash from operations of $45.4 million compared to $48.9 million in the previous year and exited 2018 with $144.1 million of cash and cash equivalents.

Now let me turn to fourth-quarter results. Our semiconductor services business performed better than expected, offsetting sustained weakness in our products and solutions business. This resulted in total revenue of $257.4 million, up 10% quarter over quarter and at the high end of our guided range. Total semiconductor revenue was $239.7 million, which included $58.4 million from Quantum. Non-semiconductor revenue, which includes display, generated $17.8 million, or 6.9% of revenue.

Total non-GAAP gross margin rose to 18.7%, a dramatic improvement from 15.7% in the third quarter. This increase reflected a full quarter of our high-margin services business. As we've shared before, margins can be influenced by a number of factors, including customer concentration, geography, product mix and volumes, and you should expect to see variances quarter to quarter.

Operating expenses as a percentage of revenue increased to 12.2% as expected due to the

Quantum acquisition. Operating margin for the fourth quarter was 6.5%, up slightly from 6.4% in the prior quarter. While heading in the right direction, it is clearly not where we want to be. The restructuring that is underway will improve efficiency and further reduce costs. By taking decisive action now we are preparing UCT to manage through an unpredictable environment while improving longer-term results and increasing our value for customers and shareholders.

Based on 39 million shares outstanding, earnings per share for the fourth quarter were $0.23, derived from net income of $8.7 million. This compares to $11.9 million net income and $0.30 per share last quarter.

Our tax rate for the quarter was 17.2% compared to 14.6% last quarter. Going forward we expect our tax rate to be in the middle to high teens, but, as always, you can expect to see variances quarter to quarter.

Turning to the balance sheet, we ended the quarter at $144.1 million in cash and cash equivalents, a decrease of $16.2 million over the prior quarter. We used $30 million to pay off joint venture debt related to the Quantum acquisition.

Cash from operations was $30.1 million, an increase of $2.8 million over the prior quarter.

Inventory decreased by $12.5 million during the quarter, and we will continue to optimize our inventory levels to closely match customer demand.

Our first-quarter outlook reflects what a lot of our peers and customers have reported already, a continued softening in our semiconductor products and solutions business. However, we do expect to see a slight increase in our services revenue. We are assuming total revenue for the first quarter to be between $230 million and $250 million.

While we expect to see upside on our bottom line as a result of the aggressive restructuring strategy we are undertaking, the benefit of that process will take some time to flow through and be fully realized.

For the first quarter we are expecting non-GAAP EPS to be between $0.09 and $0.19.

And, with that, I'd like to turn the call over to the Operator for questions.

Questions & Answers:

Operator: Thank you. [Operator Instructions] Quinn Bolton; Needham & Company.

Quinn Bolton: First, let me offer congrats on the nice gross margin improvement in the fourth quarter. I guess first one is start with your outlook for 2019. It sounds like you're taking a fairly conservative approach and not expecting any sort of recovery in WFE throughout the year. I just wanted to, one, confirm that that's the way you're thinking about it. The second question I have is: Where do you think we are in the inventory reduction process? And when do you think we would sort of potentially come back to levels of underlying consumption in 2019?

Jim Scholhamer: I'll take the first part and I'll turn it over to Sheri for the second.

So 2019, the outlook -- I think obviously the second half is uncertain. As I mentioned on the call, we don't have visibility for the second half. I think in this situation we don't know if the second half is going to recover, like the initial consensus was out there a few months ago. And I think given the uncertainty, instead of banking on a recovery I think it's in our best interest. We'll be able to manage a recovery in the second half. But given that we have at least two quarters of runway, it's a good time for us to embark on some of the longer-term cost reductions that take some time to implement in the lower period.

I guess I'll continue on with the inventory. We've been aggressively working the inventory down. We're not yet at the levels that we'd like to be. We'd like to get our turns up 1 or 2 more turns a year. But I think as we finally -- as the revenue declines have slowed down or stopped on the equipment side, we'll have some time to catch up. We've been reducing the inventory but we haven't been able to reduce it as fast as the revenue has been dropping. But now that things have stabilized, I think over the next several quarters we'll be able to recover to normal levels.

Quinn Bolton: Sorry, Jim, my question on the inventory was really meant more for where you think your customers' inventories are.

Jim Scholhamer: Oh, I'm sorry.

Quinn Bolton: Are they buying sort of at a rate lower than what they're actually shipping? Or do you think your shipments are fairly well aligned with an underlying demand at this point?

Jim Scholhamer: Right, right. Okay, yes. Sorry about that. The inventory between us and our customers, the OEM customers, is generally not as large of a concern as it is between -- the original part manufacturers are making more standard on-the-shelf items. So we did see some of that impacting Q4, the customers' finished goods inventory in some of the major modules. I think a significant portion of that has been worked out.

Quinn Bolton: Great. And then for Sheri, I think you mentioned annualized cost savings of roughly $15 million to $20 million as you implement these cost savings programs. Can you give us some sense how much of that hits the OpEx line? How much of that comes into cost of goods?

Sheri Savage: Most of it is actually cost of goods. But we will see some small increments in OpEx. So I would say probably 70% to 80% will flow through COGS and then the rest of it would go through OpEx.

Quinn Bolton: Great. I'll stop there and get back in the queue.

Operator: Karl Ackerman; Cowen and Company.

Karl Ackerman: [Indiscernible] Sheri, just going back to that last question on OpEx. Looking at March, OpEx [estimate] is a touch higher than perhaps where I would have thought. But following the implementation of the $15 million or $20 million of costs realignment actions you are taking, how should we think about the absolute level of OpEx spending for the balance of 2019? And secondarily, as you seek to improve manufacturing utilization, how should we think about gross margins for the balance of the year?

Sheri Savage: So from an OpEx perspective, obviously we're not forecasting out. I think we had mentioned last quarter that we thought we'd be in about the 12% range now that QGT is part of our overall company. They have a certain level of OpEx as well as we do, so they drove our percentage up a little bit. That's something that we're going to continue to optimize over the course of the year with these cost reductions, as well as just optimizing in general. That's what we tend to do.

So I would expect that we would be -- depending on revenue, be in the 11% to 12% range as we have been, and then continue to drive down, if possible.

Karl Ackerman: Got it. That's helpful. As a follow-up, while the services business of QGT is obviously much more insulated from the year-over-year WFE drop in 2019, I would think that they pull back and wafer starts would likely affect growth this year, at least near term. And so I guess the question is: Does the growth of your services business for mid-to-high single-digit growth in 2019 imply a massive hockey-stick ramp in the second half of this year? Or would you expect it to be relatively flattish off March levels? Thank you.

Jim Scholhamer: Yes, in the service business we actually have a lot more visibility and our bottoms-up forecast is extended quite a bit more than it is in the equipment side. And that's due to the nature of putting the facilities in place near the fabs and being very tightly bound with the particular fab start-up. So we're well positioned and there's been some fab ramp-ups that have been announced and we now see that they're going, especially in Israel, for example. And so we're pretty confident in where we're positioned in the wafer fab starts, that we've got a pretty solid forecast in that area.

Karl Ackerman: Perfect. I'll cede the floor. Thank you.

Operator: Patrick Ho; Stifel.

Patrick Ho: Maybe first off for either Jim or Sheri with regards to the restructuring, can you give a little more color where the restructuring is going to come from, whether it's from your core UCT [business] systems and product side, or on the QGT front? And the reason I'm asking is, if a lot of it is on the core UCT side of things, could have this been done earlier before the acquisition closed so you could get kind of the cost structure and some of the rationalization [indiscernible]? But if it's [technical difficulty] that kind of makes sense on a going-forward basis.

Jim Scholhamer: Yes. The answer to your question is yes, it is on the core equipment side, or

SPS side is what we call it. Obviously we have been making adjustments to that side of the business incrementally as we went along through the year of '18. Back in the fall we had a major customer call the bottom and at the time we believed that there would be a pretty quick recovery after only a quarter or so. So we took steps back then. But now that this appears to be an extended period of time, we can do the types of restructuring moves that take a longer period of time and that are more easily achieved when the factories aren't running high levels of capacity. So it really -- in order to do a lot of the things that we're doing, we needed the kind of runway that we now see that we have.

Patrick Ho: Okay. Fair enough. And then maybe as a follow-up to that, given how -- I mean, you've been in the equipment industry for a long time now and it's an extremely volatile business. Maybe it's less cyclical than it's been in the past. With these restructuring moves, how confident are you if WFE in the future gets back to that $50 billion or higher level that you can turn it on and be able to ramp quickly for your customers in those future times? And I understand the rationalization today, but if they go back to the high levels that we saw just a few quarters ago, I guess what's the confidence level we should have that it can be turned very quickly?

Jim Scholhamer: Yes. Our confidence level is very high. Without going into too much detail about the types of restructuring that we're doing, we are very confident we'll be able to have a very similar, if not improved, capacity at the end of the restructuring. It will be much more efficient. We have a lot of duplication of capabilities both within a region and then globally. And so there's an opportunity to really get scale in certain areas that make sense and remove duplication from site to site.

Patrick Ho: Great. And final question from me on the services front. It's a business that you're projecting to grow again this year. It's got obviously different market dynamics from the product side of things. How are you looking at offering I guess different types of services, analytics, and I guess maybe more even stickier solutions than the traditional parts cleaning business? How are you looking at new offerings for your customers that will drive incremental revenues over time?

Jim Scholhamer: Yes, actually that is definitely a part. We're not just doing cleaning. We're actually doing a lot of contamination control and analytics already with the ChemTrace segment of the cleaning division. So that actually is one of the key strategic elements of the service Quantum business that we bought. And we're definitely looking at how to leverage that and improve that. That is definitely one of the selling points of that capability.

Second, there's also a lot of activity technology-wise on surface treatments and surface coatings and texturing, a lot of engineering that goes along, and a lot of work being done on handling a lot of the strange new materials being taken off the periodic table and put into chips. And so we're definitely -- as a combined entity we're -- the main focus is how to put resources in that area and leverage that. Because it's already an effective arm of the service business and definitely something we want to grow.

Patrick Ho: Great. Thank you very much.

Operator: [Operator Instructions] David Dooley; Steelhead Securities.

David Dooley: Just I guess a couple clarifications. You mentioned that your Quantum business is going to grow I think high-single digits. What is the base level? What was Quantum's revenue in total in '18?

Sheri Savage: I don't have the -- I have '18 is about $235 million.

David Dooley: Okay, great. And then as far as the size of the WFE market in 2019, for planning purposes what level are you planning for? It was roughly $50 billion last year. How far down do you think it's going to be this year?

Jim Scholhamer: Yes. I don't think we really backed out or I would want to be the lone guy predicting WFE out ahead of everyone else -- but definitely not $50 billion. But we did a mixture of a bottoms-up and a top-down kind of analysis that led us to believe that it's going to be down in a similar range that it's been now. And we believe the major movements down from current revenues are kind of over with, but we don't -- I think more what we see than any further major deterioration is just a lack of sign of recovery in the second half, which may happen but at this point we don't see it.

David Dooley: What I guess I'm asking this is -- generally I think it's kind of consensus that it might be down around $42 billion from $50 billion, or roughly down at the high end of that 20% range that people are referring to. But if there's no second-half recovery, then it would be down more than that. And I guess that's kind of what I'm wondering, if you don't have visibility into a second-half recovery one way or the other, then I'm just trying to figure out what level of planning you are kind of gearing towards the industry.

Jim Scholhamer: Yes. Again, not trying to bridge down to a new WFE number, I think those are reasonable assumptions to make. And I think you could -- we could do our planning from there.

David Dooley: Okay. And then, going forward what gross margin expectation should we have for your cleaning business there?

Sheri Savage: Well, for the cleaning side, they are about double what our typical core UCT business has been. So from a combined company standpoint, we really see us being at the higher end of our range, if not beyond that, as we move in through the course of the year, depending upon how the course of the year goes from a revenue perspective. But we're going to see -- we're at the higher end of our range, as you saw in our financials for Q4.

David Dooley: I'm sorry -- was there a gross margin percentage for the business?

Sheri Savage: No. We're not providing that at this point. Really we are going to be doing segment reporting starting in Q1. So you'll start seeing the op margin for that piece of business going forward when we get into 2019's reporting.

David Dooley: Okay. Final question from me is: As far as the cost savings go I think you mentioned that they really don't hit until the second half of this calendar year, just given the timing of things. As far as the $15 million to $20 million, would we be -- kind of guess on a quarterly basis in the second half how much we might have achieved by the end of Q3 and the end of Q4, let's say?

Jim Scholhamer: Yes. Obviously we don't want to do a full-year forecast. Some of the actions have occurred as of very recently, so the actions are occurring as we speak and they'll be continued through the year. They'll be no real material effects really that we believe until the second half of the year. And obviously if you spread the cost savings over the second half and maybe some of going into the first quarter, I think you can just make some assumptions on how that might spread out.

David Dooley: Okay, thank you.

Operator: This concludes our question-and-answer session. I would like to turn the conference back over to Jim Scholhamer for any closing remarks.

Jim Scholhamer^ Yes. Thank you for joining us and we look forward to speaking with you again in April.

Operator: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.