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AMKR - Q3 2017 Amkor Technology Inc Earnings Call

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OVERVIEW:

AMKR reported 3Q17 sales of $1.14b and EPS of $0.23. Co. expects 2017 revenue to be approx. $4.1b. 4Q17 revenue is expected to be nearly $1.1b.

CORPORATE PARTICIPANTS

Greg Johnson *Amkor Technology, Inc. - VP of Finance and IR*

Megan Faust *Amkor Technology, Inc. - CFO and Corporate VP*

Stephen D. Kelley *Amkor Technology, Inc. - CEO, President and Director*

CONFERENCE CALL PARTICIPANTS

Atif Malik *Citigroup Inc, Research Division - VP and Semiconductor Capital Equipment and Specialty Semiconductor Analyst*

Randy Abrams *Crédit Suisse AG, Research Division - MD and Head of Taiwan Research in the Equity Research Department*

Shek Ming Ho *Deutsche Bank AG, Research Division - VP*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Amkor Technology Third Quarter 2017 Earnings Conference Call. My name is Tyron, and I will be your conference facilitator today. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to turn the call over to Greg Johnson, Vice President of Finance and Investor Relations. Mr. Johnson, please go ahead.

Greg Johnson - *Amkor Technology, Inc. - VP of Finance and IR*

Thank you, Tyron, and good afternoon, everyone. Joining me today are Steve Kelley, our President and Chief Executive Officer; and Megan Faust, our Chief Financial Officer.

Our earnings press release was filed with the SEC this afternoon and is available on our website. During this conference call, we will use non-GAAP financial measures, and you can find the reconciliation to the U.S. GAAP equivalent on our website. We will also make forward-looking statements about our expectations for Amkor's future performance based on the environment as we currently see it. Of course, actual results could be different. Please refer to our press release and other SEC filings for information on risk factors, uncertainties and exceptions that could cause actual results to differ materially from these expectations. Please note that the financial results discussed today are preliminary, and final data will be included in our Form 10-Q.

And now, I would like to turn the call over to Steve.

Stephen D. Kelley - *Amkor Technology, Inc. - CEO, President and Director*

Good afternoon, and thanks for joining the call. Today, I'll review our third quarter results, and our fourth quarter forecast. In addition, I'll update our progress in some key growth areas, including wafer-level packaging, Greater China and automotive.

Third quarter sales were strong, up 15% sequentially and 5% year-on-year. We benefited from robust demand in nearly all end markets as well as good factory execution. As a result, gross margin dollars increased 25% quarter-on-quarter, and we generated $74 million in free cash flow. For the year, we expect to generate over $200 million of free cash flow, our third consecutive year of free cash flow growth.

We were pleased by our broad-based revenue growth in Q3. By engaging with more customers across multiple markets and regions, I believe that Amkor will deliver a more consistent performance through all phases of the business cycle.

Our third quarter shipments into the mobile communications market were particularly strong, largely due to demand for wafer level, MEMS and advanced system-in-package technologies. In the first 9 months of 2017, our wafer-level packaging business grew 26% year-on-year. We produced these packages in 4 countries, which gives us manufacturing flexibility and provides more options for our customers.

Our wafer-level lineup includes both fan-in and fan-out technology. Amkor has long been a technology and volume leader in fan-in. With our acquisition of NANIUM, we're also a technology and volume leader in fan-out. The integration of NANIUM into Amkor is going very well. Cooperation between the teams has been excellent. Our achievements to date include the expansion of fan-out capacity at the Porto facility, an increase in fan-out customer engagements, leveraging Amkor's worldwide sales team and the successful transfer of NANIUM's fan-out technology to our K5 facility, giving customers an Asia-based manufacturing option. We are very pleased with the yield and quality performance of our fan-out production lines in both Porto and K5.

Now I'd like to touch on our progress in Greater China, where we are continuing to make solid gains. In the first 9 months of 2017, sales to Greater China customers grew 55% year-on-year. We are investing heavily in our Shanghai factory, and in our Greater China sales team to attract even more business. There continues to be a lot of upside for Amkor in Greater China.

Now let's move to automotive, Amkor's second-largest market. Amkor is the #1 outset for automotive ICs, and we are well positioned to grow in the coming years. In the first 9 months of 2017, automotive revenue grew 5% year-on-year and accounted for roughly 25% of total Amkor revenue. Amkor has a strong value proposition for automotive IC customers. We've been in the business for decades and thoroughly understand market needs. Our focus on quality, execution and technology has created the automotive mindset necessary for success over the long term. Long product life cycles mean that automotive customers place a premium on financial and geographic stability. They prefer long-term suppliers, who maintain and upgrade factories over the course of decades. So Amkor is a logical choice. We've been a stable supplier for nearly 50 years, continuously investing in new equipment and capabilities.

Traditionally, the automotive IC business has favored wire bond packaging. Automotive IC suppliers were primarily IDMs with most production taking place in their own factories. Today, driven by the need for advanced processing, storage and sensing capabilities, the market environment is changing. Many of these new advanced functions are available only in advanced packages, which are less commonly produced in IDM factories. And fabless IC makers have become an important part of the automotive IC ecosystem. Another trend in the automotive market is increased use of advanced system and package technology. Advanced SiPs improve performance by placing ICs and other components closer together. They also improve reliability by reducing the number and length of interconnects. These advanced packages are built in highly automated factories and very clean environments. At our newest facility, K5, robots are used to move product from one machine to another. This type of automation is expensive, but is valued by quality-focused customers.

In summary, we're excited about our position in the automotive market and the growth opportunities in front of us. Market forecasters predict high single-digit growth rates in the coming years, driven by increasing electronic content. And given our attractive value proposition for automotive customers, we should fully benefit as the market expands.

Moving now to our fourth quarter and full year 2017 revenue outlook. The solid fourth quarter demand in communications and our other end markets will drive revenue of nearly $1.1 billion in the fourth quarter. And based on our Q4 guidance, we expect 2017 revenues to be approximately $4.1 billion, a 6% increase over 2016, and a record for the company.

Megan will now provide more detailed financial information.

Megan Faust - *Amkor Technology, Inc. - CFO and Corporate VP*

Thank you, Steve, and good afternoon, everyone. Today, I will review our third quarter results, then provide some comments about our fourth quarter and full year activity.

Third quarter sales of $1.14 billion were an all-time record. Sales grew 15% sequentially and 5% year-on-year, which drove significant profitability for our business. Operating income increased by 60%, excluding the gain on the sale of K1 in the second quarter. EBITDA for Q3 was $243 million, and we have generated a total of $1 billion of EBITDA over the last 12 months.

We earned $0.23 per share in the quarter. Third quarter gross margin was 19.1%. As part of our 2017 Japan factory consolidation plan, we incurred approximately $10 million of onetime costs in the third quarter. We expect to complete the consolidation activities in the fourth quarter. To give you an idea of the favorable impact we expect from this initiative, our Q3 gross margin would have been over 20% under the improved cost structure. This estimate reflects the elimination of the $10 million of onetime costs that we incurred in Q3 and includes the anticipated benefits from the factory consolidation. In total, we expect annualized savings from this initiative of around $30 million, including a $25 million reduction in manufacturing costs.

Our liquidity is solid. We had $520 million in cash and around $300 million in available undrawn loans at the end of Q3. Our focus on disciplined capital expenditures has driven improved free cash flow. We generated $74 million in free cash flow in Q3 and expect to be free cash flow positive for the full year at a substantially higher level than 2016.

During the quarter, we redeemed $200 million of our senior notes due 2021 using cash on hand. We incurred $4 million in premiums and deferred debt write-offs during Q3, and we will start to realize a full quarter of interest savings in Q4.

The annualized pretax interest savings will be approximately $13 million. As of September 30, we had total debt of $1.4 billion and debt to EBITDA of 1.4x. This is a significant improvement from our ratio of 2.4x less than 2 years ago, and reflects our sustained growth of free cash flow since 2015.

Next, I will review our fourth quarter and full year activities. Operating expenses are expected to be around $115 million for the fourth quarter. R&D expense includes labor, depreciation and other cost associated with K5. The transition of some of these costs to cost of goods sold will begin in Q4, as we bring lines up to production. This transition will continue in 2018, until our operating expenses return to more traditional level. We expect our full year 2017 effective tax rate to be about 25%, and our full year 2017 forecast for capital expenditures is now around $550 million.

2017 is a remarkable year for Amkor, one with significant accomplishments and expectations for this year of transition. We are delivering record revenue. We purchased and integrated NANIUM, our factory in Portugal focused on wafer-level fan-out. We closed and sold our K1 factory in Korea, which resulted in a significant pretax gain of over $100 million. We opened, qualified and began production at our state-of-the-art K5 factory in Korea. And we will complete our Japan factory consolidation plan, which will significantly improve our manufacturing cost structure.

At the same time, operating expenses, excluding the transition cost for K5, will decline as a percent of revenue. We exercised CapEx discipline during a significant industry upcycle, and we are delivering meaningfully higher free cash flow.

With that, we will now open the call up for your questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Sidney Ho of Deutsche Bank.

Shek Ming Ho - *Deutsche Bank AG, Research Division - VP*

With regards to third quarter results, what is the biggest surprise to you for coming above the high end of your guidance range? And any areas that underperformed which you expected?

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Stephen D. Kelley - *Amkor Technology, Inc. - CEO, President and Director*

Yes. Sidney, I'll answer that. I think the biggest surprise in Q3 was the strength of the general market. When we forecasted Q3, we assumed that the general market would be flat quarter-on-quarter. And in fact, it was up significantly. So that was the biggest surprise. We also saw strength in communications, but most of that was already incorporated into our forecast.

Shek Ming Ho - *Deutsche Bank AG, Research Division - VP*

Okay. Maybe as a follow-up to that, if you look at your Q4 guidance, you're guiding revenue down about 4% at the midpoint. Surprised it's now a little stronger, given the Apple supply chain that's delayed into Q4, and also your content is increasing. What are some of the offsets that we should think about?

Stephen D. Kelley - *Amkor Technology, Inc. - CEO, President and Director*

Yes. So I think Q4 is, again, a general market story. And when I say general market, I mean everything, except for smartphones. So we're forecasting a typical seasonal pattern in consumer, in networking and the industrial markets. And basically, we're saying that, we think revenues in those segments will be roughly the same as Q2 '17 levels. We also have a little erosion due to the weakening of the yen, which is connected to our J-Devices business. But as I look at communications, that's staying very strong through Q4 for the reasons you mentioned.

Shek Ming Ho - *Deutsche Bank AG, Research Division - VP*

Okay. And then maybe last question for me. If you look at your gross margin for next quarter down 100 basis points, is that just a function of lower volume? Or are there other charges in Q4 related to factory consolidation? Or is it just increasing depreciation, expense driving that lower?

Megan Faust - *Amkor Technology, Inc. - CFO and Corporate VP*

Yes. Really what we're seeing there is a bit of change in product mix between the quarters from 1 quarter to the other. But I think what we really need to address is the profitability that we're expecting. Given that our old Amkor, excluding J-Devices, for Q3, that generated over 21% gross margin. So we're really pleased with that. So we're still experiencing with J-Devices a wait or an average down to our gross margin. So that's what our Japan consolidation plan is addressing.

Operator

Our next question is from Randy Abrams of Crédit Suisse.

Randy Abrams - *Crédit Suisse AG, Research Division - MD and Head of Taiwan Research in the Equity Research Department*

Yes. Maybe the first question's for Megan. I wanted to ask on these cost changes for your K5 ramping and the Japan consolidation. Maybe give a view, as we go into next year, the target kind of levels for gross margin once these changes are made. Then also on the OpEx, the run rate we should expect. Like, when you mentioned going back to normal, how OpEx may look, say, a couple of quarters out on a run-rate basis?

Megan Faust - *Amkor Technology, Inc. - CFO and Corporate VP*

Okay. Sure, Randy. I'll address your question on the gross margin target for 2018 first. So as mentioned, the cost savings that we're expecting with respect to the Japan consolidation activities, about $25 million in annualized manufacturing cost reductions is expected. And that's greatly going to improve Japan's performance. And so our objective is to get the corporate gross margin up to 20% for the full year of 2018. With respect to your second question on operating expenses, with our historical run rates of OpEx, we had been in and around $100 million. And then after we've integrated NANIUM, I would target a normal OpEx in the $105 million amount for your model.

Randy Abrams - *Crédit Suisse AG, Research Division - MD and Head of Taiwan Research in the Equity Research Department*

Okay. Great. And then the second question I had was, just in terms of overall industry, where it seems like there's areas lead times are stretching, and we've had a fairly good demand environment. I'm curious for your business, how your capacity as -- across your different, like advanced system-in-packaging. And then maybe how that translates to CapEx, if you kind of stay with your initial target for next year, which I think was $500 million to $550 million, but if you've kind of a target now for CapEx.

Stephen D. Kelley - *Amkor Technology, Inc. - CEO, President and Director*

Yes. I'll make some comments, Randy. Obviously, the revenue has been very strong this year, particularly in Q3 and moving into Q4. And so we have moved our CapEx target this year from roughly $500 million that we expect to end the year around $550 million in CapEx for 2017. But we've seen strength across the board. We haven't gone crazy spending, but we are spending measurably to increase capacity in some areas. One surprise for us has been the strength of the demand for 8-inch pumping. There was a forecast many years ago that much of that business would migrate to 12-inch and much of it actually stayed on an 8-inch format. So we're doing some incremental investing there, so that we're in better shape next year. We're also investing in other advanced product areas. As I look at 2018, I think we'll see CapEx slightly north of $550 million for next year. Again, we're going to exercise discipline. But we're going to invest where we see long-term potential.

Randy Abrams - *Crédit Suisse AG, Research Division - MD and Head of Taiwan Research in the Equity Research Department*

Okay. And if I can ask a follow-up to that. The -- maybe the 8-inch applications the bumping, if that's tied to some of the SiP or sensors or where the strength is. And if you could give maybe an update on the run rate for the SiP business, how it may end up tracking and where you're seeing growth there.

Stephen D. Kelley - *Amkor Technology, Inc. - CEO, President and Director*

Yes. Why don't I make a comment on the bumping, then I'll turn it over to SiP numbers to Megan. But on the pumping side, what's really driving that is smartphone demand. Because more and more, like, 2 form factors in these smartphones are: wafer-level CSP, which requires bumping; and also SiP, which requires advanced packaging capabilities over a variety of advanced packaging capabilities. So that's where we are investing primarily. SiP is also very healthy. It's more than just smartphones though. We're seeing SiP in the memory area and also automotive and other sectors, where they're seeking to improve performance and they were trying to reduce the amount of board space or area that's required to implement the function.

Megan Faust - *Amkor Technology, Inc. - CFO and Corporate VP*

Okay. And then if I understood your question, it was how much of our business is SiP. And we are increasing that. We expect for 2017 that will make up about $800 million of our business, up from 2016 of about $775 million.

Operator

(Operator Instructions) Our next question is from Atif Malik of Citigroup.

Atif Malik - *Citigroup Inc, Research Division - VP and Semiconductor Capital Equipment and Specialty Semiconductor Analyst*

Steve, I have a question on China. Can you help us understand how far the Chinese OSATs are behind in terms of catching up with the leading OSATs on advanced packages?

Stephen D. Kelley - *Amkor Technology, Inc. - CEO, President and Director*

Yes. Why don't I just comment on our position, and then I'll leave the comparisons to others. But we certainly see the Chinese OSATs investing and trying to gain more market share. So our strategy in China is to really compete on advanced packages. We do very little head-to-head competition with Chinese OSATs in wire bond. And the way we differentiate is very simple. There's 3 items. One is quality, second is execution, the third is technology. And we need to be the best in each of those 3 areas in China to be successful. And so far, I think, we're doing quite well. That's what's driving the growth in our Shanghai facility, in particular. Last year, we expanded that factory by 45%. It's now our second-largest factory in Amkor. And I anticipate that we'll be able to fill that additional space within the next 24 months. So I think we're competing very well in China today with our factory in China, supplemented by our capabilities in Korea and Taiwan. And even more importantly, we're continuing to add support people in Greater China with sales offices in Beijing, Shanghai and Shenzhen. And we have a lot more people than we did a few years ago who're actually calling on customers and bringing the opportunities to our manufacturing team.

Atif Malik - *Citigroup Inc, Research Division - VP and Semiconductor Capital Equipment and Specialty Semiconductor Analyst*

Okay. And then on the seasonality side. I mean, you talked about Q3 communication revenues to be at the same level as what you're expecting in Q4. Does that mean that you're going to see a better-than-seasonal March quarter, because historically, you've seen much stronger Q4 communication sales?

Stephen D. Kelley - *Amkor Technology, Inc. - CEO, President and Director*

Yes, I think that's what it means. I think Q1 will be stronger than normal Q1. Usually, Q1 is a major dip, but this time we're anticipating a milder dip in Q1, largely because we see the smartphone demand pushing into Q1, because of the iOS super-cycle continuing. And also we think we'll see continued reasonably strong demand out of China.

Atif Malik - *Citigroup Inc, Research Division - VP and Semiconductor Capital Equipment and Specialty Semiconductor Analyst*

Okay. And one last one for Megan. In your 20% gross margin goal or target for next year, what kind of pricing assumption you're assuming?

Megan Faust - *Amkor Technology, Inc. - CFO and Corporate VP*

I think another way to look at it, when -- I think if you're talking about pricing, you're talking about ASP or the top line revenue. I think we need to look at it more from a total Amkor as growth year-over-year. So we're looking to be within, what we would expect for the semimarkets, if not a little bit better.

Greg Johnson - *Amkor Technology, Inc. - VP of Finance and IR*

Thanks very much, Atif. There are no more questions. So that ends the Q&A portion of the call. I'd like to turn it back to Steve for his closing remarks.

Stephen D. Kelley - *Amkor Technology, Inc. - CEO, President and Director*

I'd like to recap our key messages. We had a strong third quarter with revenues up 15% sequentially. We're pleased with our fourth quarter outlook. And our key initiatives are on track, driving revenue growth on a broader base of customers and applications. Thank you for joining the call today.

Operator

Ladies and gentlemen, this concludes today's conference. You may now disconnect.