First Quarter of the Year Ended December 31, 2020

Conference Call (Held April 27, 2020) Question & Answer Summary

<Questioner 1>

Q: First of all, I would like to ask you about your 1Q results. Large sales are being achieved in line with the disclosed plans, and the margins seem better than expected. There hardly seems to be any impact of the coronavirus here. Is it correct to understand that the impact is mainly from February and March, and the products for which revenue was recorded have been shipped smoothly? That's my first question.

A: Focusing on the impact of the coronavirus on shipping, two back-end factories in China and three back-end factories in Malaysia have been affected. The results of the two back-end factories in China were generally in line with forecasts in the first quarter. In the case of Malaysia, the restrictions had not been factored in at the timing of the forecast, so this amount was additionally affected.

However, the actual amount of the impact was small, due to the fact that the duration of suspension was short, and that there was a sweep-out of inventory.

Q: In that case, while there was an impact on shipments, it seems that you have not been affected so much by the weakness of the end market for Automotive. And as automotive manufacturers were engaged in production activities to a certain extent, the impact has not shown in your business.

A: That's right. Our revenue is based on sell-in to the channel, but in terms of figures that are closer to actual demand, we are tracing sell-through figures as much as possible. Regarding this first quarter for Automotive, the sell-through is almost flat YoY.

As we know, while global production of cars is down by about 25%, our sell-through impact of 1% probably means that products are accumulating somewhere. The supply chain consists of several tiers, so probably we should understand that there is a time lag before adjustments start affecting our Company.

Therefore, I believe that the impact of demand softening will emerge in the near future.

Q: Besides Automotive, what about Industrial and Infrastructure? How do you see these channel inventories?

A: Infrastructure is showing relatively solid performance. In our case, Infrastructure can be divided into data centers and comms infrastructure. The latter is affected by individual factors but in general, is somewhat strong compared to our view at the beginning of the year.

Industrials, on the other hand, have been relatively strong at present. We are aware of the strong momentum of growth accompanying the resumption of production in China, as well as the rapid increase in production particularly in healthcare equipment. We are also seeing somewhat surprising figures from some applications showing strong performance. In addition, we are receiving orders in a relatively stable manner for the second quarter. It's possible that some of the industrial products will face adjustments from the third quarter onwards. Until then, it seems that the customers are rather prioritizing the procurement of parts and materials.

Anyway, we do not think the drop there will be as large and rapid as with Automotive in general.

Q: My second question concerns the actual products in the Automotive, Industrial, Infrastructure, and IoT businesses. Can you explain in more detail about the results overachieving or underachieving? Also, I'd like to know the ongoing trend in April and May. Please tell us more about the upside or downside by product.

A: Shinkai will answer first, and Yamamoto will add comments as necessary.

(Shinkai) First of all, compared to Q1 forecasts, Automotive applications decreased more than expected. One reason is that the Automotive side was impacted more by production constraints in the back-end factories in Malaysia, and demand was weaker than anticipated mainly in Automotive MCUs.

On the other hand, applications for Industrial, Infrastructure, and IoT ended stronger than expected. By segment, both Industrial and Infrastructure saw positive growth. In terms of specific products, there was a pull-in of demand for such products as SoCs used for medical equipment. The first quarter has largely been based on such a mix.

(Yamamoto) This is Yamamoto, Executive Vice President at Renesas. For Automotive, as mentioned from Shibata, of course there was a downside in China due to the coronavirus until the second half of 1Q. But Tier1 had not yet reached a trend of major suspensions of order by March, so I understand that there has been no major upswing or downswing by product throughout the entire first quarter.

In April and May, there is a tremendous impact from the suspension of global OEM operations, particularly in North America and Europe. With Tier1 main customers, I understand that we are currently receiving various requests, including those that are not yet official, as they watch new figures coming out in April, May and June.

Q: The third question is related to the situation in April-May, but I think the utilization rate is now rising in 8-inch and 12-inch line. Do you think this trend will continue in April-May? I think that the utilization rate will change depending on the situation. Are you currently operating at a higher level than the first quarter, and what is the outlook?

A: Because production adjustments are made every year around Golden Week, the capacity utilization rate will decrease during periods when long holidays are originally set in the calendar. Therefore, the second quarter plan originally assumes a slightly lower utilization rate than the first quarter. This is not related to recent changes in demand.

On the other hand, as we have been saying, the outlook is unclear now, so we are discussing to make adjustments to demand at some time and then adjust production accordingly. Nothing has been decided yet, but we are currently studying this matter.

<Questioner 2>

Q: As the first question, I would like to ask about the gross margin. The actual gross margin was 47.3%, which is 1.3 percentage points higher than your plan. I understand that the utilization rate and revenue were basically in line with the plan, so I would like to ask once again why the margin was higher than expected and whether this will continue from the second quarter onward. That is the first question.

A: As for the gross margin, the biggest factor is that the cost of manufacturing has been reduced considerably against our expectations. This is rather a one-time occurrence, as the maintenance costs we incur in the first half of the fiscal year decreased. Therefore, the main factor is one that will not continue through the second quarter onwards.

Q: Just to confirm, it is not like a time lag, but the amount for this year was not as large as expected, and the effect will end here?

A: Yes, your understanding is correct.

Q: Regarding the second question, I would like to ask you about the inventory. As for the inventory in the channel, I think you mentioned that there seems to be an accumulation in Automotives. I thought you originally intended to accumulate BCP inventories this first quarter and second quarter. Given that the situation has changed a little, is the level of internal inventories at the end of first quarter under control?

A: Maybe the explanation wasn't good, but we don't think the inventory of our devices is piling up in the channel. There is probably more stock beyond the channel, and we don’t know whether that stock is in the form of semiconductor devices, automotive parts, or finished vehicles. From the channel, shipments have so far been made almost too smoothly, and we expect that adjustments will be made after some time lag. That’s the background of the previous comment.

So, at this point in time, both our on-hand inventory and our channel inventory are under control, for better or worse. We want to be cautious that inventories will not build up in the face of the prospect of a sharp decline in demand in the foreseeable future.

On the other hand, the market is likely to recover at some time, so it is not a good idea for anyone to cause a supply problem at that time. From the perspective of BCP inventory, we have been saying that we allow for our operations to slightly increase inventory this fiscal year, so we would like to manage inventory with some flexibility to the extent that cash is not lying idle there.

Q: This will be my third and last question. For the second quarter, you have disclosed a baseline forecast of revenue. What are the assumptions behind this baseline revenue, and what are the assumptions for the Automotive and non-Automotive?

A: First, Shinkai will answer your question. I might add some comments afterwards.

(Shinkai) Regarding the baseline revenue forecast, based on the outlook we constantly make, we factored in recent fluctuations in demand as much as possible and made an assumption of the effect on a sell-in basis. Therefore, we assume that the current production situation at automotive factories, for example, is reasonably reflected, but I think there are many aspects that have not yet been factored in.

This is a decrease of about 6% on a quarterly basis, but if we break it down, it will be around negative 15% for Automotive, and positive low single digits for Industrial, Infrastructure, and IoT. Automotive-related business was negative overall, regardless of products or segments. The only exception is SoC, which has a long lead-time and is expected to have a smaller negative impact. In the Industrial, Infrastructure, and IoT segments, we expect a negative figure in IoT, which is overall impacted by the macroeconomy, and slightly positive in terms of other segments.

(Shibata) Just to add one point, we are inevitably impacted by foreign exchange rates compared with US companies, which is a factor where the actual situation becomes difficult to read. Currently, there is a possibility that the exchange rate will also fluctuate greatly, and about half of the QoQ decline in our baseline forecast is due to exchange rates. The remaining half is about volume, or real demand. So, when you look at the numbers, I think it would be good to keep that rough breakdown in mind.

Q: Excuse me, you said that you have included factors that you currently see and can reasonably factor in. Is it correct to understand that you are including factors that have been shared already, instead of having a conservative outlook or something like that has not been announced?

A: Basically, if we provide the same guideline as before, it will be the baseline.

<Questioner 3>

Q: I would first like to confirm the improvement in the gross margin. It seems that the SG&A ratio is not moving so much, so I have some doubts about whether it can be explained only by one-time expenses. Especially if the former IDT products were good, there seems to have been some improvement in the mix itself. Once again, can you explain why the profit was better than expected? Also, if possible, it would be appreciated if there were something like a breakdown in actual numbers. That's my first question.

A: Regarding the gross profit, of the 3.8 percentage points, I mentioned that about one-fourth is due to decrease in COGS, and the actual figure is JPY1.1 billion. The majority of this is the reduction in maintenance costs as a part of manufacturing costs, which I mentioned earlier. There are many other things, but what has contributed most to the improvement of gross profit on a net basis is this part.

Q: Then, is the other part the improvement in mix?

A: There are many small factors, including improvements in the mix. Another factor is the negative impact on production due to temporary suspension of back-end processes. Against the forecast, there are some accounting factors, such as the cost allocated to COGS being smaller than expected, in relation to the change in the classification of expense recording. All in all, I think that the aforementioned reduction in manufacturing costs is the most significant part in a real sense.

Q: My second question concerns the negative 6% in the second quarter. The negative 15% for Automotive is convincing considering the situation at the moment. Could you tell us a little more about the situation in Industrial and Infrastructure? Because you mentioned that the parts other than IoT were positive, I'm not sure how big the business for medical devices was, or whether IDT is going to be positive QoQ, so appreciate your explanation.

A: Generally speaking, this is a repetition of the previous comments, but production in China is rising quite rapidly. This is not for anything particular, but it means that production is resuming in quite a number of areas. Also, we believe that the manufacturers of factory automation equipment are increasing their inventories in part to avoid missing orders, globally and in Japan. Therefore, the QoQ situation is that the strength in Industrial is continuing.

As for Infrastructure, this will also basically be a repetition, but we are expecting an increase in the mid-teens for data centers, and a considerable QoQ increase for base stations in the double-digit range. As a result, the Infrastructure as a whole, like data centers, is expected to land in around the mid-teens at the end, and a little less than 10% in terms of our revenue.

Q: Finally, about the approach to inventory, I think that there is a view not to accumulate inventories, but from the perspective of BCP inventories, will you tell us whether the current level is appropriate or not? Also, if something like a pandemic occurs in the future, there is a possibility that the supply chain will be severed, so one approach would be to prepare with a relatively large amount. Given this, do you intend to maintain the current level of inventory and turnover months going forward, or is there a possibility that it will increase in the medium term? This is my last question.

A: That's a difficult question. We don't know how long the pandemic will last, and if the pandemic spreads, supply chains will be disrupted, but demand is likely to decline rapidly as well. It doesn't make sense to hold inventory as demand declines, so I think the level of BCP will also change. Rather than focusing on predicting the future, we would like to minimize upside and downside fluctuations as much as possible by responding swiftly to changes.

Nevertheless, it goes without saying that some markets are growing for some reason, such as data centers and 5G. There are growing subsegments, such as EV-related or ADAS-related fields, which we have talked about before, or the timing of the launch of new platforms, so we might look at them individually and hold a little more inventory at hand if we think the market will grow anyway. On the other hand, with areas that we think move completely in tandem with short-term production, we will tighten our control a little.

I believe that last year, we were able to demonstrate that our own factory, including the front-end, is able to respond to changes in demand quite quickly, so I appreciate that you accept this point. On the other hand, the lead time for outsourcing to foundries is longer than the Company's own factory, so there may be a slight time lag for this point, resulting in an increase or decrease in inventories.

In any case, I would like to reiterate that it is difficult to forecast demand, but this year we intend to conduct operations with a little more leeway than last year's level of inventory turnover.

<Questioner 4>

Q: I have two questions.

First regarding the second quarter, the baseline revenue is QoQ minus 6%, which seems to be a very mild decline than what you would imagine. Based on this revenue, I imagine that you will be fully able to maintain profitability on a NON-GAAP, as well as on a GAAP basis. Please tell us as much about your idea of profit or loss if you achieve this baseline revenue.

My second question concerns the utilization rate. Based on what I've heard, it has fallen considerably in the second quarter around the middle of last year. I think you decreased it to the low- to middle- 50% range on an input basis, but it seemed that such a level of operational adjustments are not assumed. Of course, I think it will depend on the pandemic going forward, but could you tell us how much you are thinking about the degree of the operational adjustment that you are currently seeing?

A: Shinkai will answer you first.

(Shinkai) Regarding the profit-loss assumptions of the baseline revenue, our assumption is that revenue is negative 6% QoQ, gross margin is around 45%, and operating margin is around 14%. These are NON-GAAP figures.

Also in the case of GAAP, as you commented, we believe that we will be profitable down to the bottom line. However, all of the above estimates are based on the assumption that the revenue will be achieved.

(Shibata) Your question on utilization is hard to answer. As of today, I assume that it will not be as large an adjustment as last year. Particularly this year, it is foundries rather than our own factories that should be closely monitored in various ways, including upside and downside, and so in terms of the extent of adjustment at our own factories, I am assuming that it will not be that large. We will update our outlook further from here until after the Golden Week holiday, and we will update production plans, accordingly, so please keep in mind that in some cases, our view may change after the update.

<Questioner 5>

Q: I have three questions.

First, I'd like to know about demand that increased more than expected after the impact of the coronavirus. For example, I'd like to know your feeling on customers accumulating inventory, or data centers and medical care for which prospects have improved or changed.

Second, if the current lockdown situation in April to June continues through the next couple of quarters, you mentioned that Q2 revenue may decline by 6% QoQ. I don't know whether this is meaningful, but regarding real demand, you mentioned a decline of over 20% in Automotive for CY2020, so will revenue decline further QoQ? There is also seasonality, so please tell me whether you currently think revenue will decrease if the situation continues.

Finally, my third question is your policy around testing for impairment of goodwill and other intangible assets. If business performance deteriorates, what will be the impairment test on the retail side, and how do you communicate with auditors? It can be the current possibility, which I'd like to understand as a risk factor.

A: In response to your questions, I would like to answer first, and Shinkai will follow up on the numerical aspects as necessary.

(Shibata) First, regarding impairment, there are many technical criteria related to factors like two consecutive periods or market capitalization, but they are basically all triggers for considering impairment. My understanding is that this applies to significant change in the price of assets such as commodities, where their value drops significantly in case we sold it right now. In our case, as some people are saying, if the world really changes and results in a significant impact on human behaviors, including activity patterns involving consumer durables such as automotives, which will significantly reduce the size of the market, I believe that we have to consider impairment quite seriously.

However, unless the market shrinks significantly and permanently or evaporates in some cases, we have confirmed that impairment will not be needed in light of the criteria. Based on our best knowledge as of today, it is highly unlikely that we have to seriously consider such matters.

Regarding your first question, sorry to repeat this, but as you stated in your comments, the area showing strength in the coronavirus crisis is healthcare. Apart from healthcare, manufacturing equipment in general is strong, but this may be a matter of early timing rather than real strength. This is about all kinds of manufacturing equipment used in factories.

Also, data centers are trending very strongly as already mentioned. Regarding communication infrastructure, if you look at our figures, it is not necessarily stronger than last year. But compared to the outlook we originally had at the beginning of the year prior to the coronavirus, government-led initiatives, particularly in China, are accelerating considerably, and 5G demand is seeing significant growth in terms of scale and timing.

As for 4G, although the basic trend is declining, there is also the launch of some products designed in the past, so there are special or timing-related factors that are contributing to strength. That's my comment on which segments have underlying strength and which may be strong only in the short term under the current environment.

Regarding your second question, we do not provide any guidance from the third quarter onwards as it is difficult to predict. As I mentioned in the previous comment, when we talk about the demand and outlook for Automotive in the first quarter and second quarter, while we recognize a pure decline in OEM production due to the suspension of production lines, the trend is so positive that it may not even be factored in depending on the case.

In addition, if we consider prolonged suspension of production, slow ramp-up following the suspension, or decline in demand itself as downside risk, it is probably correct to think that such factors are not yet included in the figures we have presented, so it's probably correct to think that adjustments will be made in the future, as of today.

(Shinkai) Regarding the first question about goodwill, let me add the fact that there was no need to determine an impairment or conduct an impairment test based on the results of this first quarter.

<Questioner 6>

Q: I have two questions. There was some talk about the profit at baseline in the previous question. I think the operating margin in NON-GAAP was 14%, so if my calculation is correct, I think that in QoQ the profit margin will decline. Please tell us about the background behind this.

On a related note, I understand that you are working on reducing OPEX, so how much will that contribute in April-June? My first question is, what kind of negative factors will cancel out that cost reduction, and what is the overall QoQ decline in margins?

A: First, the top line will decline by 6%, so the margins will fall according to the volume of the top line, and then there is an OPEX factor. The forecast of a slight QoQ increase is reflected in the 14% given before. We anticipate that measures such as reducing OPEX will still kick in additionally from here. Please understand that this 14% figure is just a reference.

Q: Just to confirm, why does OPEX increase QoQ in Q2? And are the efforts being made showing their effect from the third quarter, or is it merely that the effects are not included in this plan?

A: First, we have not fully incorporated the effects into this second quarter. One reason that OPEX increases from the first to second quarter is the cost pushed out of the first quarter into the second quarter, which is a major factor behind this QoQ increase. I would like to reiterate that, as we have not factored in any reduction measures from this point, we believe that the actual situation will change a little more.

Q: Regarding my second question, I fully understand that the future is completely unclear, but I recall that you explained at analyst day that in your original plan, you expected market share to expand from around 2021. Under these circumstances, do you see that in the course of discussions with customers, such expectations will decline in the future? Are there any changes in expectations about that? Could you tell me about this point?

A: In terms of our share by segment, device, and application in which we operate, we do not expect any major fluctuations resulting from the current crisis.

However, most likely, if we take a broad view of the market, such as semiconductors as a whole, I assume there will be changes in market share based on whether you're a supplier focusing on data centers and cloud computing, which are growing even in these circumstances, or a supplier engaging in things like automotives or industrials. Therefore, if we talk about the application segments that we view as our core products, the answer is that we simply don't think there will be such large fluctuations.

Q: Thank you very much. Excuse me, but in terms of what I wanted to ask, last year or the year before, I think there was a case where the initially anticipated ADAS project was delayed because of the delay in the full launch of ADAS, so the expected design did not lead to sales. I wanted to confirm if there are any events that may change the situation and affect what you anticipate for next year onwards.

A: That's a good question. At the moment, there is no such major change that is apparent. To be honest, it is difficult to say. At least I can say that for the large-scale products and large-scale opportunities that we are frequently talking about, at this point we haven’t heard about anything disappearing or being skipped. Even in this environment, we are deepening our day-to-day discussions, so the answer is that there are no factors that could change the outlook at this point.

On the other hand, when we look at factors other than such large-scale opportunities, we are working to accelerate near-term and mid-term growth more strongly than before, and designs are performing quite favorably at the moment. It may not be very helpful information for analysts, but we are strongly accelerating what we can do, and seeing at least good long-term results.

Apart from that, we are doing quite extensive follow-up in order to avoid losing major deals and products. And even in the event of a contingency, we are accelerating our activities day by day in order to build up a large number of opportunities, not exactly small-scale, but in a more careful manner than ever before.

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