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Seagate Technology Plc (STX)

Q3 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and welcome to the Seagate Technology fiscal third quarter 2020 financial results conference call. My name is Jason, and I will be your coordinator for today. At this time, all participants are in a listen-only mode. Following the prepared remarks, there will be a question-and-answer session. As a reminder, this conference is being recorded for replay purposes.

At this time, I would like to turn the call over to Shanye Hudson, Vice President, Investor Relations. Please proceed, Shanye.

Shanye Hudson

Vice President-Investor Relations, Seagate Technology Plc

Thank you. Good Afternoon, everyone, and welcome to today's call. Joining me are Dave Mosley, Seagate's Chief Executive Officer; and Gianluca Romano, our Chief Financial Officer. We've posted our earnings press release and detailed supplemental information for our March 2020 quarter on the Investors section of our website.

During today's call, we will refer to GAAP and non-GAAP measures. Non-GAAP figures are reconciled to GAAP figures in the earnings press release posted on our website and Form 8-K that was filed with the SEC. We've not reconciled certain non-GAAP outlook measures because material items that may impact these measures are out of our control and/or cannot be reasonably predicted. Therefore, reconciliation to the corresponding GAAP measures is not available without unreasonable effort.

As a reminder, this call contains forward-looking statements, including our June quarter financial outlook and expectations about our financial performance, market demand, industry growth trends, planned product introductions, ability to ramp production, future growth opportunities, possible effects of the economic conditions worldwide resulting from the COVID-19 pandemic and general market conditions. These statements are based on management's current views and assumptions and should not be relied upon as of any subsequent date. Actual results may vary materially from today's statements.

Information concerning our risks, uncertainties, and other factors that could cause results to differ from these forward-looking statements are contained in our most recent Form 10-K filed with the SEC and our Form 8-K filed with the SEC today and the supplemental information posted on the Investors section of our website. Following our prepared remarks, we'll open the call for questions.

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

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

Thanks, Shanye. Good afternoon, everyone, and thanks for joining us.

I would typically start the call by sharing highlights from the quarter; however, we are living in an extraordinary time shaped by the coronavirus outbreak. Therefore, I'd like to take a moment to send our thoughts to those affected by the virus and recognize the healthcare professionals and other workers who are selflessly supporting our communities through this crisis.

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For Seagate, the health and well-being of our employees, customers and suppliers have always been the top priority. Throughout this crisis, we have taken decisive actions to safeguard our global workforce and maintain continuity of the business to support our customers. In this period of unprecedented uncertainty, the Seagate teams performed very well.

We delivered March quarter revenue and non-GAAP EPS above the midpoint of our guided ranges, supported by record sales of our nearline products and strong cost discipline, and we also continued to generate healthy free cash flow. In January, before our last earnings call, we mobilized our global enterprise crisis team and immediately put strong protective measures in place. This cross-organizational team has been very effective in identifying issues, developing protocols and mitigating risks, which has enabled Seagate to rapidly deploy site-specific learnings and best practices across our entire global footprint and share them with our partners and suppliers.

In addition to health and safety concerns, this very dynamic situation has caused disruptions in our supply chain and those of our manufacturing partners and our customers as they also adapt to rapid shifts in demand. Our teams acted with speed and agility to tackle a wide range of operational challenges from securing parts to produce our drives, obtaining materials to package them, and addressing logistics challenges to ship finished goods in order to support customer demand in the March quarter.

As the situation evolved, more governments began instituting measures to prevent the virus' spread, including limiting the movement of people and restricting business operations. We continue to comply with government rules and guidelines across all of our sites. All of our manufacturing facilities are operating in compliance with local government regulations. Our R&D organizations are able to continue their efforts through a combination of telework and skeleton support staff in our labs.

Today, our supply chain in certain parts of the world are almost fully recovered including China, Taiwan and South Korea, and we see indications for conditions to begin improving in other regions of the world. We are engaging with our suppliers and manufacturing partners on a daily basis; and we'll continue to take action to mitigate supply risks, including building inventory levels on critical components, supplementing our own supply with external sources where possible, and utilizing external labor resources to support our workforce needs. Based on our current assumptions, we do expect some supply-related impact in the June quarter.

The demand environment was equally dynamic. At the surface, the quarter played out largely as expected, with a seasonal slowdown in the consumer-facing legacy markets, offset by growing demand for mass capacity storage supporting cloud and data center growth. However, the underlying drivers and customer buying patterns were shaped more by the onset of the coronavirus outbreak rather than any historical trend.

Looking at the markets, Seagate's third quarter revenue from mass capacity storage increased 18% quarter over quarter and 68% year over year, supported by record sales of our nearline products. Demand from cloud and hyperscale customers was strong and accelerated towards the end of the quarter, due in part to the overnight rise in data consumption driven by the remote economy brought on by the pandemic.

In this remote model, work moves from the office to our homes, education shifts from onsite to online, and entertainment is delivered at high bandwidth digitally to our living rooms. With millions of people simultaneously adopting these changes, endpoint devices such as mobile phones and laptops are overwhelming the edge of the network. This is a real-time example of what we have referred to as IT 4.0, the move of data to the edge.

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To address latency and bandwidth issues, compute and storage infrastructure is required at the edge. A recent post by a leading US hyperscale company further supports this view, speaking of plans to rapidly deploy new capacity in order to address the increase in global demand, while also encouraging customers to seek solutions at the regional level to address their specific requirements, closer to their needs at the edge.

We believe these trends drove a broadening of cloud customer demand for our nearline products towards the end of the quarter, which has continued into the June quarter. The strength in nearline demand more than offset below-seasonal sales for video and image applications, such as smart cities, safety, and surveillance, as COVID-19 related disruptions impacted sales early in the quarter.

More positively, within these applications, average capacity per drive increased to over 4 terabytes in the March quarter, consistent with our expectations for both average capacity and total exabytes to increase with the advent of high-definition video and the desire to maintain more data for longer periods of time at the edge.

We've also spoken of the long-term demand drivers associated with the advent of IT 4.0 and adoption of video and image sensors to support new applications. One such example surfaced over the last couple of months as healthcare workers and municipalities employed biometric sensors as a protective screening measure against the virus. As a matter of fact, Seagate uses the same technology to help protect our own employees. These applications, combined with the transition to higher capacity drives, create meaningful growth opportunities for our mass capacity storage solutions in this market over the long term.

Finally, let me touch on legacy markets, which encompass the consumer electronics space, desktop and notebook PCs, and performance mission-critical applications. March is typically a slower demand quarter for these markets following the holiday rush and Chinese New Year. With the consumer markets among the first to get impacted by the onset of the coronavirus, we saw greater than expected revenue declines for our consumer and desktop PC drives.

While we see pockets of healthy demand in certain markets and are starting to see improvements across our supply chain, the full extent of the COVID-19 related impacts to the broader economy and associated impact to our market and business operations are yet unknown. Recovery will likely be dictated by the duration of the outbreak, timing of containment, and duration of restrictive measures. Given the fluidity of the situation, we are not going to provide a detailed view for the second half of the calendar year at this time.

For Seagate, we stand on solid financial footing with a strong balance sheet, ample liquidity, and exposure to secular growth trends that are tied to the world's insatiable demand for data and the need for mass capacity storage and data management solutions. We continue to advance our technology and execute our product roadmap to address that need. Our 16-terabyte high-capacity drives continued to successfully ramp to meet customer demand, with exabyte and unit volume shipments more than doubling quarter over quarter.

We remain on track with our 18-terabyte plans and began shipping in limited quantities to select customers as part of our system solution. Because the 18-terabyte drives employ the same architecture as the 16-terabytes, they can be deployed quickly and seamlessly in our systems, providing customers with a storage building block of up to 1.9 petabytes at a very attractive price per petabyte in the industry.

Last quarter, I spoke of Seagate Lyve Drive, a series of seamlessly integrated storage solutions to cost-effectively move data between endpoints, edge, and core cloud environments. Our systems will play an integral part of Seagate's data management solution platform, particularly for enterprise customers as they move to a hybrid cloud approach for their workloads.

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This quarter, we introduced Seagate Lyve Labs, which is a collaborative platform intended to help our enterprise customers and partners develop data management solutions tailored to their future workload requirements. While still in its infancy, this program has garnered tremendous feedback from customers, and I'm incredibly excited by our early engagements.

With that, I'll turn the call over to Gianluca to go into more depth on our March quarter results and share our outlook for the June quarter.

Gianluca Romano

Chief Financial Officer & Executive Vice President, Seagate Technology Plc

Thank you, Dave.

Seagate has demonstrated its ability to adapt quickly to changing market conditions. Over the past year, we have successfully managed the business through hyperscale digestion period, geopolitical challenges, and macroeconomic uncertainty. All the while, we maintain our focus and discipline on managing expenses, optimizing profitability and generating strong free cash flow.

The March quarter represented one of the most challenging operating environment, and we continue to deliver solid financial performance consistent with these objectives. We have achieved revenue of $2.72 billion, up 1% sequentially and up 18% year over year. Non-GAAP operating margin of 15.5%, relatively flat quarter over quarter and up 282 basis points year over year. And non-GAAP earning per share of $1.38, up 2% sequentially and 49% year over year.

We also generated solid free cash flow, maintain a strong balance sheet, and believe our liquidity and financial flexibility will continue to meet the need of the business, fund our dividend, and opportunistically retire shares. Our operational execution was equally solid as we shipped 120 exabytes of HDD capacity, an increase of 12% quarter over quarter. Additionally, average capacity per drive topped 4 terabytes, a 26% jump from last quarter and nearly 70% from the prior-year period, reflecting the ongoing shift towards mass capacity storage in the cloud and at the edge.

In the March quarter, mass capacity storage increased to 57% of total revenue and represented 62% of total HDD revenue. These figures are up from 49% and 53%, respectively, in the December quarter. Exabyte shipments into the mass capacity storage markets increased 28% sequentially to a record level of 91 exabytes. This strong sequential growth was underpinned by demand for nearline drive, attributed primarily to cloud and hyperscale customers.

Revenue from 16-terabyte nearline drives more than doubled quarter over quarter, reflecting the strong momentum we see for these products. Total nearline shipments increased to 76 exabytes, with an average capacity of nearly 10 terabytes per drive, another new record. Looking ahead to the June quarter, we see similar demand trends among global cloud and hyperscale customers, and believe investment level will remain generally aligned with each customer's ramp cycle.

Following a very strong December quarter, revenue from video and image applications was down double digits sequentially, while still up on a year-over-year basis. COVID-19-related disruption exacerbated the anticipated seasonal slowdown in the March quarter. We have already started to see some demand improvement in certain Asian markets, and expect revenue to normalize when the pandemic impact abates on a global basis.

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Our revenue contribution from the legacy markets decreased to 36% of March quarter revenue, down from 43% in the December quarter, as initial virus outbreak and extended Chinese New Year impacting demand for consumer electronics. Exabyte shipments into these markets declined 18% sequentially to 29 exabytes. For Seagate, the impact was most pronounced in our consumer and desktop PC drives, where we have the greatest exposure.

Conversely, mission-critical sales were in line with our expectation, following typical seasonal patterns for the quarter. Mission-critical revenue and exabyte shipments declined quarter over quarter. However, both were up on a year-over-year basis, supporting our view for a long demand tail. The remaining 7% of March quarter revenue was derived from our non-HDD business, which was down 10% sequentially. A majority of the decline is attributed to our system business and COVID-19-related supply constraints, as our manufacturing partners were impacted by factory shutdowns and labor shortages.

Looking ahead to the June quarter, we are seeing an improvement in the supply conditions, particularly among our ODM partners. However, it could take a couple of quarters to fully recover. Longer term, we anticipate meaningful growth opportunities with our system solution, driven by increasing demand for data at the edge and the adoption of private cloud.

Non-GAAP gross margin declined 67 basis points to 28%, which includes an approximate 100-basis point impact from higher logistics, underutilization, and operational costs associated with COVID-19 disruptions. On a sequential basis, the increased contribution from mass capacity drives offset these higher costs, resulting in relatively flat HDD margin. However, our non-HDD business were also impacted by COVID-19 related challenges and weighed down the gross margin at the corporate level.

Non-GAAP operating expenses were $340 million, down 3% sequentially and slightly below our prior estimates, reflecting lower travel and other business expenses, following the COVID-19 outbreak. We're actively working on opportunities to lower our cost structure and drive further operational efficiencies.

Through the combination of stable gross margin and control spending, we delivered non-GAAP operating income of $422 million and adjusted EBITDA above $500 million. This translates to non-GAAP operating margin of approximately 15.5% of revenue, which is at the upper end of our long-term financial model range. Based on a share count of approximately 263 million shares, non-GAAP EPS for the March quarter was $1.38, above our guidance midpoint.

Capital expenditures were $130 million in the March quarter, reflecting our confidence in the business and flexibility to align our capital needs with market conditions. Year-to-date, we have invested approximately 6% of revenue. Based on our current outlook, we would expect fiscal year CapEx to be at or slightly below the low end of our target range of between 6% and 8% of revenue.

We generated free cash flow of $260 million in the March quarter, and continue to deploy capital to reward shareholders through our longstanding capital return program, demonstrating our confidence and in sustainable free cash flow generation.

We utilized $195 million to retire approximately 4 million ordinary shares, exiting the quarter with 257 million shares outstanding, and we used $170 million to fund our dividend. Our board also approved a quarterly dividend payment of $0.65 per share, payable on July 8, 2020. We remain committed to our capital strategy of investing in our business first and funding our dividend and opportunistically retiring shares. Our robust balance sheet and liquidity are the foundation of our financial strength.

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As of the end of the quarter, cash and cash equivalents were $1.6 billion, and we have access to up to an additional $1.5 billion through our revolver. Gross debt was $4.1 billion, with net debt of $2.5 billion, both fairly flat with the prior quarter. Our debt portfolio has a staggered maturity, with less than 13% of the balance coming due within the next two fiscal years.

Total inventory declined slightly to $1.1 billion, as we support the strong demand for nearline products while proactively building inventory for some critical components to better manage through the current market environment.

Looking ahead to our outlook for the June quarter, we expect demand for our nearline products to continue into the June quarter, supported by ongoing cloud and hyperscale investment. In China, we have started to see demand recovery in certain markets, including video and image applications. However, there is still considerable uncertainty at the macro level, which limits our visibility.

In this highly dynamic environment, we will focus on what we can control to minimize the financial impact to our business while continuing to address challenges to meet customer demand. Based on our current operational risk assessment, we expect that the cost impact from COVID-19 will be somewhat higher in the June quarter.

With this in mind, we expect the following for the June quarter. Revenue to be $2.6 billion, plus or minus 7%. At the midpoint of our revenue guidance, we expect non-GAAP operating margin to be at the upper end of our long-term target range of 13% to 16% of revenue. And non-GAAP EPS is expected to be $1.28, plus or minus 10%.

In closing, our March quarter results demonstrate our ability to execute well in profoundly challenging business conditions. I'm confident that our innovative product portfolio, financial strength, and sustainable cash flow generation position us well to navigate the near-term business challenges and capture long-term opportunities associated with the secular demand for mass capacity storage.

I will now turn the call back to Dave for final comments.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

Thanks, Gianluca. In summary, our March quarter performance demonstrates the resilience of Seagate's business model, our focus on execution, and the dedication of our employees. Despite the current business environment, we are tracking to the financial model we outlined last September. We are delivering operating margins at the high end of our target range of 13% to 16% of revenue. We are forecasting annual revenue growth of 2%, based on our midpoint of our June guidance range. And we have remained committed to returning at least 50% of free cash flow to our shareholders.

The start of fiscal year 2020, we shared an expectation for our mass capacity storage shipments to be well above the long-term compound annual growth rate of 35% to 40%. We still expect to exceed that range for the fiscal year, as well as calendar year 2020. Increasing demand for data is fueling long-term secular growth for mass capacity storage. I shared examples today that suggest an even greater reliance on data in this new remote economy brought on by the pandemic, and likewise, a greater need for compute and storage in the cloud and at the edge.

With our strong technology road map and broad product portfolio, I am confident that Seagate will emerge from this challenging business environment well-positioned for these opportunities. I'd like to express my sincere appreciation to our employees for their extraordinary efforts during the quarter. I would also like to thank our

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suppliers and our partners and customers for their close collaboration through this period and for their ongoing trust in Seagate.

With that, Gianluca and I are happy to take your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question today comes from the line of Karl Ackerman from Cowen. Your line is open.

Karl Ackerman
Analyst, Cowen and Company LLC

Q

Hey. Thank you. Everyone, I hope you're healthy and safe in the current environment. Two questions, if I may. The first one is, I guess, is more of a clarification, if I may. How disruptive, from a manufacturing standpoint or margin standpoint, were the shutdowns across Asia-Pacific countries in the March quarter? And I'm just kind of curious if you expect any manufacturing disruptions in the June quarter. And I have a follow-up.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Karl, I would say fairly disruptive, not just for us in the specific facilities that we run, but also upstream in our supply chain. There were a number of shutdowns that affected us and started really in late January, right after Chinese New Year. And then downstream of us as well, the ODMs, and I think that's gotten a lot of press, were also disrupted.

So quantitatively, we're not going to really break it out, but you can imagine the kinds of disruptions. And then the biggest are logistics issues because we did have inventory in a lot of positions that we're able to flex around and we run multiple sourcing strategies as well. But just the logistics, getting stuff through checkpoints and making sure we have the right parts in the right place at the right time was an issue.

Karl Ackerman
Analyst, Cowen and Company LLC

Q

I guess just to follow-up on that, if I may, I mean, has that – sorry, go ahead.

Gianluca Romano
Chief Financial Officer & Executive Vice President, Seagate Technology Plc

A

You were asking about the impact of the gross margin, I guess.

Karl Ackerman
Analyst, Cowen and Company LLC

Q

Yes, correct.

Gianluca Romano
Chief Financial Officer & Executive Vice President, Seagate Technology Plc

A

In the script it's about 1%.

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Karl Ackerman
Analyst, Cowen and Company LLC

Q

That's helpful, thank you. To the extent you can, how do we think about the exabyte trajectory in the June quarter and perhaps for the balance of the calendar year, given an extension of the current investment cycle for nearline drives? Given the longer lead times associated with these nearline drives, what sort of order visibility or backlog do you have for your nearline production? Thank you.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Again, given the downstream of us, there's a lot of disruption still. You don't know exactly how people are going to build through or even be able to get the parts and the people required to build through what they need. But I would think of it as relatively flat. We do see demand, but can that demand actually be monetized in this quarter? Is it pushed out? And the reason that the demand, we think, is out there is because of all the changes in work location that we talked about. So, if that helps you.

Operator: Your next question comes from the line of Aaron Rakers from Wells Fargo. Your line is open.

Jake Wilhelm
Analyst, Wells Fargo Securities LLC

Q

Hi. This is Jake on for Aaron. Congrats on the great quarter. I was wondering if you could delve a little bit deeper into the competitive landscape for the 18-terabyte drive.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

I don't really know how much about – I can't really speak that much about the competitor. I would say that it's a fairly disrupted environment for all the customers right now. So certainty of supply on 16-terabytes is something that we're very focused on. Our 16-terabyte, if you remember, has the same platform as our 18-terabyte. So we changed the heads, we changed the disks, a few other minor changes. We get pretty good leverage now that we're way up the curve, and we understand what the supply chain needs to look like for that. So we're fairly confident going to 18-terabytes.

I think that over the next six months or a year, probably people are going to be a little bit more bashful on product transitions. That's just how I think about it. They'll go with more certainty towards what they can get and what they can integrate.

Jake Wilhelm
Analyst, Wells Fargo Securities LLC

Q

Okay. And then, just to follow up on that, can you talk a little bit about the adoption you're seeing for the 16TB, like the breadth of adoption, customer profiles, anything along those lines?

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

I think the growth has been good. This is the fastest ramp we've ever done in heads and disks, and we talked about that last quarter as well. So the ramp continues to go well, and we're working with a lot of partners to make sure that we're getting them what they need through those transition periods. So adoption is clearly good, with us

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being 3 million drives plus under our belts now and driving significantly north. From there, we've got good adoption across multiple customers in all geographies.

Jake Wilhelm
Analyst, Wells Fargo Securities LLC

Q

Okay, great. Thank you so much.

Operator: Your next question comes from the line of Ananda Baruah from Loop Capital. Your line is open.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Hi. Good afternoon, guys. Thanks for taking the questions. I have a couple, if I could, too, as well. Gianluca, could you – I just want to make sure I understand the full gross margin bridge. It sounds like it's 100 basis points from COVID-related costs, logistics, et cetera. Could you also quantify for us? You mentioned non-hard drive business gross margin impact. Is there any way to quantify that for us?

And then my hunch is that there's this sort of maybe other category, given that you had such strong nearline exabyte shipments Q-over-Q. Is there something else that would have not allowed some of that to fall through to the bottom line? And then I have a follow-up, if I could. Thanks.

Gianluca Romano
Chief Financial Officer & Executive Vice President, Seagate Technology Plc

A

I would say the mix has actually impacted our bottom line, and we came out with a very strong EPS. In terms of gross margin impact from the COVID-19, we did not separate between, I would say, hard disk and non-hard disk, but in total for the corporation it's about 100 basis points. The mix has actually helped the gross margin for the hard disk drive. And with the increase in the mass capacity part of the business, we actually got more or less flat sequentially in terms of just hard disk gross margin.

On the non-hard disk, we had, of course, the impact of COVID in term of costs. We also had some impact on the supply chain. So our system solution part of the business was a little bit lower than what we were expecting, and that has negatively impacted the non-hard disk part of the business in terms of gross margin.

So overall, the gross margin was down 67 basis points. If you just look at the hard disk part of the business, it was basically flat. And again, if you take out the impact of COVID-19, we were actually a little bit higher sequentially.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Gianluca, that's helpful. And I guess why would 50% – it's such strong growth in nearline Q-over-Q, and seemingly just backing into the implied ASP sort of growth as well, why wouldn't the margins of the kind of apples-to-apples have been up more than 100 basis points? I just want to make sure that we're not missing anything here.

Gianluca Romano
Chief Financial Officer & Executive Vice President, Seagate Technology Plc

A

No, I don't think you are missing anything, I think the big increase in volume. Of course, there's also some impact on the average decline in pricing. And I think we had a very good quarter. I think we moved the mix at a level that

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we wanted, and we are well-positioned for the next quarter and the near future. The mass capacity part of the business is really growing strongly.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Okay then. Yeah, it really is. Okay. Just one – thanks. One quick follow-up, Dave, if I could, you had mentioned that some of the hyperscale demand could potentially move into the September quarter, based on what you're seeing. Do you have an expectation just in general? I know it's super early, but that hyperscale demand could remain solid into the September quarter or for the September quarter? Any context there would be helpful. Thanks.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Yeah. Ananda, I made reference to the fact that we think that the change in locality of data is actually going to have to get answered by the cloud customers and also buy some edge installs as well. So if you listened to the prepared remarks, there are specific comments about that. We still think that's going to happen. It's early relative to all the global disruptions is what we've seen, is to know what exactly happens when and what can happen when because of the logistics of what's going on this quarter. But from my perspective, I do think that this change in data locality and the growth of the cloud will affect the next cycle for sure.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Thanks a lot, guys. That's really helpful.

Operator: Your next question comes from the line of Katy Huberty from Morgan Stanley. Your line is open.

Kathryn Lynn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Thank you. Good afternoon. Congrats on the really great execution this quarter. I guess first question for Dave. A lot of companies, as I'm sure you've seen, have pulled guidance. And so, can you put some context around the visibility you feel you have into demand and supply in the June quarter relative to a normal period? And then, what do you think are the biggest potential variables that would put you at the upper end or lower end of the guidance ranges you've provided? And then, I have a follow-up.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Yeah. Thanks, Katy. I think that reflecting the fact that our ranges are opened up, we're still signaling to everyone that it's a more volatile time than we're normally accustomed to. So exactly to your first point, these are not normal times for anyone.

Supply has risks and demand has risks. For the demand side, I would point to the question I just answered as to why. On the supply side, there's been a number of different shutdowns and border closures and things like that that affect not just our facilities but also our upstream facilities. So, we're cognizant of that. So, it's not a normal quarter relative to visibility. But I do think that it's incumbent upon our management team to come out and tell everybody what the visibility that we have is today, given that we're 2.5 weeks into the quarter already. So, we're doing that.

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Kathryn Lynn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

That's great. Thank you. And, Gianluca, I think you said on gross margin that the impact from COVID will be bigger in June than it was in March. So in that context, should we think about gross margins falling sequentially because of that bigger headwind, or does the strength in nearline offset COVID?

Gianluca Romano
Chief Financial Officer & Executive Vice President, Seagate Technology Plc

A

Yes. Katy, we don't guide gross margin. And yeah, we expect a little bit higher cost, possibly higher cost related to the COVID-19. Of course, it depends from how long those restrictions will be in place. In terms of gross margin, we expect a mix fairly similar quarter over quarter, so another very good quarter with mass capacity storage volume. And of course, the additional cost will impact a little bit our EPS. And our revenue is also – we guided to be lower sequentially.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Yeah. So we factored that in as much as we could into the existing guide, Katy.

Kathryn Lynn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Thanks. And just one quick follow-up to that on OpEx, Gianluca, I think you've talked about holding it relatively constant with the $340 million. Is that still the case or does COVID give you some opportunity to remove costs in the next couple quarters?

Gianluca Romano
Chief Financial Officer & Executive Vice President, Seagate Technology Plc

A

Well, we always look at opportunities mainly to get more efficient, not only to reduce our cost. In the very short term, I don't think we will reduce our cost. Our fiscal Q3, in terms of OpEx, was a very low cost. So, we expect to be fairly similar in fiscal Q4. But Dave and I are always looking at opportunities. So, we will look and decide if we have anything – any opportunity that we want to take in the next few quarters.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

To the point, there are opportunities as well that we may want to redeploy against. So the world has changed considerably. And as we see some of those opportunities, we may invest slightly against them as well.

Kathryn Lynn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Okay, thank you so much.

Operator: Your next question comes from the line of Steven Fox from Fox Advisors. Your line is open.

Steven Fox
Analyst, Fox Advisors

Q

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Thanks. Good afternoon. Dave, couple questions on just the supply chain. So in prior downturns, there's been periods where some of your smaller component suppliers have run into trouble. You've helped them out, but there's been interim issues not like this. But can you just sort of talk about the relative health of getting those last 5% of the BOM filled out right now? And then, I had a follow-up.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Thanks, and it's something I'm very mindful of. At Seagate, we have 40,000 people roughly streaming our supply chain. My estimate would be that's 0.5 million people. We need to make sure that economically, they're getting what they need, because otherwise, if some of those companies go away, then we have our own issues as well. So, it's important for us to make sure that our supply chain is as healthy as it possibly can be. We feel that responsibility.

There are issues, for sure, but we are working with suppliers very closely to make sure that they're getting through those issues. And I think everyone who participates in our supply chain, since it's so large, understands and appreciates the complexities, and understands how we're all in this together in some respects, right, so that we have to make sure that we take care of each other.

Steven Fox
Analyst, Fox Advisors

Q

That's helpful. And then, just so I understand sort of the base case thinking here in the guidance. You mentioned sort of some improvements in sort of manufacturing, obviously, China. But is there a thinking here that like by the time you get to the month of June, that things are materially better or operating about the same in terms of supply chain? How can we think about what kind of level of improvement broadly you're thinking about logistically? Thanks.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Oh, gosh. I wish I could say I predict it well, but the period we've just been through from a supply chain disruption perspective was pretty big. You compare it back to 2008 when I was running operations or 2011, very, very different times now global. And there's been a lot of, I'll just call it multi-week disruptions. So, I do like to hope that some of this is becoming a little bit more predictable to manage, although I think that there will still be surprises. And that's why we've got to all be very communicative up and down the supply chain. And I really appreciate that our customers appreciate this as well. They're making sure that they help out, and everybody is being as predictable of demand as they can right now because that's the way that we can tell everybody exactly what we need.

Steven Fox
Analyst, Fox Advisors

Q

That's helpful. Thank you.

Operator: Your next question comes from the line of Jim Suva from Citigroup Investment Research. Your line is open.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

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Thank you very much. When you talked about the additional COVID expenses, I believe you said approximately 100 basis points, if I heard correctly. Do you think that those are kind of permanent and we should just kind of build that in for quite a long time, or have you learned through this quarter, maybe those are near-term costs that you find a way to quickly get back out of the system? Thank you.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc
A

Thanks, Jim. Yeah. I think there's a couple different buckets. Largely, the ones that are impacting us are more temporary, because you look at under absorption from factories that were actually shuttered or running not at full capacity, or if you look at logistics in particular, February was so slow, March was so busy, a lot of airfreight was needed and there just weren't a lot of airplanes to be had. So we have a lot of logistics costs that went up in the period, and there are still reverberations of that. All those kinds of things are temporary. We do believe, at some point, we'll figure that out or add a little bit of inventory, take advantage of other lanes and things like that.

There are some – back to the supply chain questions that Steven asked, I think there's some things that we have to watch out for on the supply base as well that may be more permanent. And so, we're still working with individual suppliers to make sure that that health throughout the entire supply chain doesn't affect us all in demand.

Jim Suva
Analyst, Citigroup Global Markets, Inc.
Q

Great, thank you so much for the additional details.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc
A

Okay. Thanks, Jim.

Operator: Your next question comes from the line of Tristan Gerra from Baird. Your line is open.

Dustin Scaringe
Analyst, Robert W. Baird & Co., Inc.
Q

Hey, guys. This is actually Dustin speaking for Tristan. I know you mentioned demand in China. Your consumer segment is coming back. I'm wondering if you could give a little more color on that, how they're tracking, and the potential impact on revenues just for this coming quarter and maybe for the rest of the year. Thanks.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc
A

Sure. Yeah. Thanks. As you can well imagine, after Chinese New Year, things turned off, and especially on the consumer side, I would say the distribution channel as well. And then, in places like Europe and the Middle East, we saw that turn off later, but the same kind of behavior later. There were also pockets of large pops because as people went to working from home, there were large buy cycles that went on. People are buying disk drives basically to move data around.

So, very intriguing to watch the tactical signals in the quarter. Some of it's becoming a little bit more predictable in Q4, but there's still fairly massive disruption, and it's not back to a point where it's not impacted by the week-to-

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week buying patterns of people. But this is not what we forecast for our fiscal Q3 or Q4 for that matter. And we're just in the consumer markets, in particular, more in reactionary mode.

Dustin Scaringe
Analyst, Robert W. Baird & Co., Inc.

Q

That's great. Thank you.

Operator: Your next question comes from the line of Patrick Ho from Stifel. Your line is open.

Patrick J. Ho
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thank you very much. And glad to hear everyone is well. Dave, maybe on a qualitative level, given the strong demand that you continue to see for mass capacity drives and from the data center and cloud segments, can you just give your thoughts about what's actual demand and what potentially could be some inventory building even by that segment? Even though we are hearing positive stuff on data centers, where do you think, I guess, that kind of demarcation between inventory building versus actual demand that's out there right now?

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Okay. Thanks, Patrick. I don't think there is a lot of inventory demand building. I think people are very cautious with their investments right now. From my discussions with most of my customers, they understand that. Some of the larger cloud service providers know how fast it's going to be before they can actually monetize the capacity that they're putting online, so they're mindful of those lead times, but they also see demand that's further out in time than I do.

I would also say that on some of the mass capacity drives, surveillance is what I'm thinking about now. The market was actually quite soft. We talked about this in our prepared remarks. Although the capacity points moved up, so things moved above 4 terabytes per drive for the first time there and could go to 6-terabytes and 8-terabytes over the next year or two. And so I think that mass capacity, if you will, the demand will come back because it was so impacted by the early days of this pandemic.

Patrick J. Ho
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Great, thank you very much.

Operator: Your next question comes from the line of Mark Miller from Benchmark. Your line is open.

Mark Miller
Analyst, The Benchmark Co. LLC

Q

Thank you for the question, and great job on handling the situation, which is difficult for everyone. Just was wondering if you could give us an update on HAMR. Does that still look like it goes out the door late in the year? And I'm just wondering about the margin profile of HAMR drives compared to your other drives.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

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Mark, I think we've talked about before that the HAMR platform – the platform that we've ramped with the 16 terabytes is where we're going to introduce HAMR as well. So from all the other componentry, if you look at it that way, the cost impact is we're already down the cost curve quite a bit. So we think the economics of HAMR will still be very favorable.

Yes is the answer to your question, we're still on target with HAMR. It's hard to do experiments at the same clip that we were doing them a few months ago, but the experiments also have long lead times. So things don't change that much on some of the wafer lead times that we have now. And so we still have pretty good visibility, and I'm really proud of the progress the team is making.

Mark Miller
Analyst, The Benchmark Co. LLC

Q

So, I just wanted to clarify. Do you think you'll be shipping 20 terabytes by the end of the year of HAMR?

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

That's right.

Mark Miller
Analyst, The Benchmark Co. LLC

Q

Okay, thank you.

Operator: Your next question comes from the line of Shannon Cross from Cross Research. Your line is open.

Shannon Cross
Cross Research, Analyst

Q

Thank you very much. I was just curious. Have you seen any delays in customer qualifications for 16-terabyte drives given some of the challenges with the employees in the office and that related to COVID? And then I have a follow-up. Thanks.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Shannon, I would answer that question as a no. We were already pretty deep into the qualification cycles when this thing first hit. I do think that running the big scale, say, for example, reliability test beds that are sometimes done as you ramp programs, there weren't a lot of people to plug those beds. Sometimes you couldn't get the attention of the builders because they weren't even in the office. So yes, there are impacts to some of the late-stage qualification and maybe the early stage of the next generation. I made reference to that earlier, but I don't really think it impacted our plans because we were already so deep in 16 terabytes.

Shannon Cross
Cross Research, Analyst

Q

Okay, great. And then just a question on capital return. You talked about maintaining the long-term framework. I'm just curious, in discussions, there's been a number of companies who have either halted share repurchase or others. You obviously have a strong balance sheet and cash flow. But I'm just curious as to how some of those discussions are going, when you talk to the board, what the puts and takes are as you look at sort of a questionable or I guess sort of unknown second half at this point. Thank you.

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Gianluca Romano
Chief Financial Officer & Executive Vice President, Seagate Technology Plc

A

Yes, Shannon. Well, as you said, we are still generating very strong free cash flow, and we have a very good liquidity level. Between our cash at $1.6 billion and our revolver of $1.5 billion, I think we can operate more or less in a normal way in terms of capital allocation. Of course, we will focus, as usual, internally first, so supporting our business, and of course, paying our dividend. In terms of share buyback, we always look at how attractive is the opportunity. So we will do more or less depending from how we consider the share price to be attractive.

Shannon Cross
Cross Research, Analyst

Q

Thank you.

Operator: Your next question comes from the line of Mehdi Hosseini from SIG. Your line is open.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Thanks for squeezing me in. Dave, just one follow-up question. All the good ones have been asked. What would be your expectation for nearline exabyte shipment in calendar year 2020 if COVID-19 had not taken place?

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Mehdi, that's a tough question. I think we were talking about 35% to 40% and being above that range as well before. And I think there's been a lot of dynamics because of this locality, change in locality of data, which suggests to me that maybe some of the typical cyclicality has changed. I don't know that we can actually see that yet because COVID has disrupted a lot more than just this. Of course, there's a lot of pieces of the supply chain and your ability to build it through.

But my thinking is from a fundamental data demand perspective, the cycle is bigger next time just because that all the working from home, the reliance on the cloud that everybody has. And then, frankly speaking, the data demand for AI and surveillance and other tools that might be used to go invest is bigger. I know there are a lot of businesses that have been disrupted as well, and so seeing our way through that into that final demand is still pretty hard, if that helps you.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

That's right. Thank you for your answer. Just one quick follow-up. If this shift to the cloud is permanent, could we see a scenario where nearline exabyte were to account for a much bigger mix of your total exabyte shipment, total revenue to the extent that even if the new game console were to be disruptive to hard disk drive, the nearline strength would more than offset that?

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

We've been involved in the gaming consoles for almost 20 years now, and I'm a big fan of the market. From an exabyte perspective, to your question, it's relatively immaterial. In the last two quarters, we shipped 225-plus exabytes and only one – less than 1 exabyte is going to gaming consoles. So when it comes to pivoting heads

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and disks over, I think we can very easily do that. We'll continue to support that market. But depending on what our customers need, we'll be there to answer the call.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Okay, thank you.

Operator: Your next question comes from the line of Mitch Steves from RBC Capital Markets. Your line is open.

Mitch Steves
Analyst, RBC Capital Markets LLC

Q

I had two questions. One on the OpEx side and one kind of on the demand side. So I'll start with the OpEx one. So something we've heard from a lot of these companies in the Silicon Valley is that they're actually going to get savings long-term off of this virus or outbreak, however you want to phrase it, because they're going to allow certain employees to start working from home, reduce some travel costs, and generally reduce OpEx. So I guess I'm wondering why or potentially if you guys are going to go down that path and why you wouldn't go down that path to reduce OpEx.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

I think that's probably – I'll let Gianluca answer, but, Mitch, I think that's probably less relevant for us. Most of our OpEx is around our core technology development and not as much SG&A, if you will. So go ahead.

Gianluca Romano
Chief Financial Officer & Executive Vice President, Seagate Technology Plc

A

In fiscal Q3, we reduced our OpEx by about $10 million, so I think we did a lot in terms of cost reduction. In general, our OpEx as a percentage of revenue and also as a total value is fairly small. So we have always been very prudent and conservative with our OpEx spending.

Of course, as I said before, we will continue to look for opportunity to even lower this cost or improve our efficiency. And now, the travel or other benefit from working from home, if it is something that will benefit the company, of course, we will take a look at that.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

We're very happy with where we're managing from an operating income at the top of our range again. If something changes yet in the world, and there's a lot of things changing, then we look for investments. We may take advantage of that investment at the time to go after some new revenue streams or something. But I look at it very differently, I think, than most tech companies, because most of our OpEx is really pointed at our core technology rather than sales and marketing.

Mitch Steves
Analyst, RBC Capital Markets LLC

Q

Okay, got you. And then the second one, I hate to be this blunt about it, but it's kind of one of the big ones that we're going to get a lot of. So since legacy was down pretty substantially Q-over-Q, do you guys have any conviction on this potentially being some share shift? Because from what we've heard, commercial PCs and kind

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of PCs in general are actually a little bit better than feared, at least from a channel check. So, maybe you could help us understand what you guys think happened there and what numbers you guys think would be surprising if you saw a lot of the PC share shift.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

PC, becoming less and less relevant for us every day to the point. Certainly, notebook PC, we're continuing to support a few customers, but it's really – those parts of the legacy market aren't as relevant. Legacy being consumer electronics or legacy, which was dramatically disrupted in the quarter, Q-on-Q, right, a little bit more than we even forecast.

And then mission-critical, which to our point before has a fairly long tail out there just given the preponderance of slots that are out there in the world. There's a lot going on inside the legacy. So it's a little bit more pronounced than we thought, but not really because of PC cyclicality or anything like that. And a small temporary head-fake PC bump is not going to help us tremendously either. We're just not as exposed to it.

Mitch Steves
Analyst, RBC Capital Markets LLC

Q

Got it, thank you.

Operator: Your next question comes from the line of Nik Todorov from Longbow Research. Your line is open.

Nik Todorov
Analyst, Longbow Research LLC

Q

Thanks. Dave and Gianluca, can you please talk about the pricing environment for mass capacity? I mean, in our field work, we've heard of efforts by you and others in the industry to pass-through higher cost due to COVID to customers. And at the same time, I'm looking at the flattish nearline exabyte comment for June quarter, and that implies dollar per terabyte declines in the high-end of the historical range. So, can you give us any color if there's anything changing in the pricing environment right now?

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

I'd say the pricing is relatively benign. The higher costs are largely associated with logistics. As you can imagine, especially it has to positively get there overnight, but we just don't have the routes that are at the same cost as they were three months ago or six months ago. From my perspective, those are the hardest problems that we have operationally; they're temporary. We will get through them at some point, but those are the hardest problems that we have. And we're sharing some of the burden downstream, especially for people who are expediting us. I think, over time, we could obviously go to different routes. But I don't think that that's a super meaningful – in the trajectory of nearline dollar per terabyte, if you look at that trajectory over the last couple of years, I don't think it's a meaningful shift.

Nik Todorov
Analyst, Longbow Research LLC

Q

Okay. And if I can just follow up. I think Mehdi asked the question, but I'm just trying to understand the impact to potential disruptions for the June quarter. If there was no COVID-19, what do you think nearline exabytes would have been? And you can give us a range for June quarter.

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William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

I think just too hard to do all the puts and takes there. There's too many disruptions, I think, to really go there. I do think that cloud service providers were continuing to invest against the secular growth in data that we see. And some of that is disrupted, whether or not at all times out in June or whether or not it gets pulled in because people are more full than they thought they would be in the cloud, and they can actually find ways to get it put online. I mean, it's just – it's too hard to say versus prior baseline.

I will say that our capacity that we have is still a little bit underutilized, and that's affecting our costs. So, we could clearly have done more. But depending on how we see that on those very, very short lead time capital, we may pull back on that. On the long lead time capital, we're still investing because it's against this massive secular growth.

Nik Todorov
Analyst, Longbow Research LLC

Q

Okay. Got it. Thanks, guys. Good luck.

Operator: Your final question comes from the line of C.J. Muse from Evercore ISI. Your line is open.

Q

Hi. This is [ph] Kevin (57:29) on for C.J. So, just wanted to think how to think of the contribution, the quarter-over-quarter weakness and surveillance from maybe the COVID impact versus potentially maybe inventory they built kind of last Q. And so, do you still think, I guess, normalized rate is like higher than what you shipped this quarter?

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Oh, interesting. Yeah. I think it's more COVID-related because basically the month of February, all the channels were turned off. So, I think companies are still out selling their solutions, and some of these solutions are becoming more and more relevant in today's world. And like we talked about, the rise of the edge, we can see that, but the ability for us to get product to market for those customers to integrate it and then get it to their end users, I mean, with everybody at home and around the world, I think that's a primary driver of what's going on in Q3.

Q

Okay. Thank you. And then I think you mentioned a similar platform on 18-terabyte versus 16-terabyte. So, curious if you'll see potential shorter qualifying times there; and if so, maybe like how many months could you shorten that time potentially.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Yeah. We believe so. I think to your point, Kevin, it's been a long – these technology transitions take a long time. They're not something we just turn on like a light switch. And going through all the qualifications, all the different parts that we have in the drive, so we're really happy with the 16-terabyte platform being up the ramp. It's the first

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time in a long, long time we've been able to leverage for multiple generations. And the confidence that we have in all those parts is going to translate into confidence in the qual timeline completion to this. I don't really want to quantify it right now because I think someone asked earlier, I think it was Shannon, about the overall cycles given how disrupted everyone is that has to run these tests and things like that. I don't really want to try to quantify it yet. But I do think, from our perspective, it adds to our confidence for sure.

Q

Thank you.

Operator: That concludes Q&A. And I would now like to turn the call back to management for closing remarks.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

Okay. Thanks, Jason.

To summarize, Seagate is doing an outstanding job of managing through these uncertain times, and we continue to generate cash and have a strong balance sheet and liquidity to weather the storm. Over the long-term, we see no change to the strong secular growth in mass capacity storage, and we'll continue to execute our strategy to meet that demand.

I'd like to once again thank our customers, suppliers, business partners, and our employees for their incredible efforts during the March quarter, and our investors for their ongoing support of Seagate. Thanks, everyone, for joining us today.

Operator: That concludes today's conference call. Thank you, everyone, for joining. You may now disconnect.

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