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Seagate Technology Holdings Plc (STX)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and welcome to the Seagate Technology Fiscal Second Quarter 2022 Financial Results Conference Call. My name is Brent 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, Senior Vice President, Investor Relations and Treasury. Please proceed, Shanye.

Shanye Hudson

Senior Vice President-Investor Relations & Treasury, Seagate Technology Holdings 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 December quarter fiscal 2022 results on the Investors section of our website.

During today's call, we'll 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 included in our 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.

Before we begin, I'd like to remind you that today's call contains forward-looking statements, including our March 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 information available to us as of today, 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 and 10-Q filed with the SEC, our Form 8-K filed with the SEC today, and the supplemental information posted on the Investors section of our website. As always, following our prepared remarks, we'll open the call up for questions.

Now I'll hand the call over to you Dave.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Holdings Plc

Thank you, Shanye and hello to everyone joining us on today's call. Seagate ended calendar year 2021 on a high note delivering another solid performance in the December quarter highlighted by revenue of $3.12 billion, our best in over six years, and non-GAAP EPS of $2.41, representing the highest level in nearly a decade. This performance is all the more impressive in light of the supply chain disruptions and inflationary pressures we are experiencing today and further demonstrates the consistent execution, operational agility and sharp focus on expense discipline that we have displayed throughout the year.

To that point in calendar year 2021, we achieved revenue of nearly $12 billion, up 18% compared with the prior calendar year. We expanded non-GAAP EPS by more than 75% and we grew free cash flow by nearly 40%. Truly an outstanding year of growth that shows we're capitalizing on the secular tailwinds driving long-term mass capacity storage demand.

As we shared many times before, driving profitability and free cash flow generation remain two of Seagate's top priority and underpin our focus on enhancing value for our customers and shareholders. Since the onset of the pandemic, we have consistently executed our product roadmap and made investments to deliver cost-efficient, higher capacity drives that offer business value for our customers while also enhancing Seagate's financial profile.

We extended our proven common platform drive family from 16 to 18 and now to 20-terabytes and beyond. We also addressed cloud customers' performance needs through our industry leading dual actuator technology. We've made these advancements while notably returning more than $4 billion to our shareholders through our quarterly dividend and share repurchase programs. Our execution and product momentum position Seagate to deliver a third consecutive calendar year of top line growth. We currently expect calendar year 2022 revenue to increase 3% to 6% with further growth beyond, consistent with our long-term model range.

Let me spend a few minutes discussing the current business environment. In the December quarter, we again generated record mass capacity revenue with growth led by demand from cloud customers. We achieved our highest ever cloud customer revenue supported by sales of our 18-terabyte nearline products which significantly increased quarter-over-quarter, consistent with our plans.

HDDs are critical enabling technology for the growing datasphere. As we shared a year ago at our analyst event and our results demonstrate, HDDs have a well-established place in the data center ecosystem and we do not expect that to change over the next decade or longer. For the past couple of years, Seagate has been a beneficiary of increasing cloud data center investments to support remote work, remote education and the digital transformation trends that continue to take place. Analysts forecast another year of strong double-digit cloud CapEx growth in calendar 2022.

Several powerful themes emerged from this year's CES Conference that support our longer-term demand outlook and underscore a clear business need to capture, access and analyze massive and growing volumes of data. New use cases highlight how data intensive applications such as AI, autonomous vehicles or smart cities can improve business or social value and drive demand for mass capacity storage both in the cloud and at the edge.

We have previously shared how emerging use cases at the edge are driving meaningful opportunities within the VIA markets. These applications utilize high definition video and AI analytics to capture and extract data value. In the December quarter, sales of our VIA products remained healthy and we expect the March quarter to be seasonably slower consistent with historical trend. Longer term, we continue to forecast exabyte growth in the mid-teens supported by expanding opportunities at the edge.

Moving to our other markets, sequential growth from the cloud in the December quarter was somewhat counterbalanced by lower revenue in the enterprise, OEM and legacy PC markets that we attribute primarily to the COVID-related supply challenges that dominated broader industry headlines.

As we indicated last quarter, non-HDD component shortages are disrupting some of our enterprise and OEM customers' shipment plans which impact both mass capacity nearline and legacy mission-critical drives. We're mindful that these supply pressures and other COVID-related measures could further weigh on the typical March

quarter seasonality that we anticipate in the VIA and legacy markets. However, customers are managing through the tight supply environment and expect conditions to ease over the next couple of quarters.

Seasonality and temporary constraints aside, the long-term mass capacity demand trends remain strong. In this environment, we remain focused on exercising capital discipline to align supply with demand and continue to engage with customers on their longer-term demand requirements to ensure that our production capacity plans align with their future ramp timelines. With lead times for high-capacity HDDs of six months or longer, an increasing portion of our nearline drive revenue is under long-term agreements with momentum to expand even further.

We are executing our innovative mass capacity roadmap and cost reduction plans to offer compelling value proposition for our customers that is also financially attractive for Seagate. We are ramping 20-terabyte drives, extending our common platform to a third-generation. For a couple of quarters now, cloud data center customers have shown very strong pull for these drives.

The TCO value proposition for transitioning to higher capacity drives is compelling. Consider first that a move from 18 to 20 terabytes represents an 11% boost in storage capacity and then layer on the savings realized across the data center build out. At the system level, customers require less networking gear and other ancillary parts to support the same storage capacity.

On both fronts, these gains translate to meaningful cost efficiencies which may be further enhanced given the part shortages and inflationary pressures in today's market. All indications point to a very steep production ramp for our 20-terabyte products with the potential of surpassing the record setting ramp we saw for our 16-terabyte drives.

As a result, we are using the seasonal slowdown in the March quarter to stage our factory operations to support strong 20-terabyte demand as the year unfolds. Our common platform approach helps to facilitate this process by enabling us to quickly transition and ramp new products into the market.

Our 20-terabyte drives highly leverage the head and media technology that power our 18-terabyte product family, making the production process well understood and hasten time to yield. This strategy also provides manufacturing flexibility and improves our overall cost efficiencies across the breadth of our common platform family, which currently spans 16 through 20-terabyte capacities for CMR products with some customer stretching to 22 terabytes using SMR feature sets.

We are driving additional manufacturing and cost benefits by incorporating the same media and head technology to produce cost optimized drives, spanning capacities down to 2 terabyte drives. In addition to the improving manufacturing flexibility, these cost optimized drives can require fewer heads and disks which offset some of the nearer-term inflationary component pressures.

In the December quarter, the revenue contribution from products using higher areal density drives increased to nearly 40% of total HDD revenue. Wrapping up, we entered the March quarter amid a challenging supply environment. However, I remain optimistic for conditions to gradually improve.

Importantly, our strong product portfolio and operational execution puts Seagate in excellent position to deliver on our long-term revenue growth model and generate strong free cash flow in 2022 and beyond, underpinned by growing demand for mass capacity storage beyond 20 terabytes.

I'll now hand the call over to Gianluca to cover the financial results.

Gianluca Romano

Chief Financial Officer & Executive Vice President, Seagate Technology Holdings Plc

Thank you, Dave. Seagate continued to execute well and navigate a complex business environment to deliver solid financial performance aligned with our expectations. In the December quarter, we grew revenue to $3.12 billion, up 19% year-over-year; delivered non-GAAP operating margin of nearly 20%, up 520 basis points year-over-year; and increased non-GAAP EPS to $2.41, up 87% year-over-year.

In our hard disk drive business, we achieved a fifth consecutive quarter of record capacity shipments totaling 163 exabyte, up 3% sequentially and up 26% year-on-year.

Ongoing cloud demand for our nearline product supported mass capacity revenue of $2 billion, up 1% sequentially and up 35% compared with the prior-year period. Shipments into the mass capacity market totaled 137 exabytes, up 4% sequentially and 41% year-over-year. Nearline remains our fastest growing product segment, with revenue outpacing the broader mass capacity business. In the December quarter, we increased shipment to 111 exabytes, up 4% sequentially and 56% year-on-year supported by the ongoing cloud adoption of 18-terabyte drives, as well as healthy demand for mid-capacity products from enterprise and OEM customers.

Our 20 terabytes product family is growing strong customer interest, and we're continuing to scale 18-terabyte shipments while also preparing for an anticipated steep 20-terabyte ramp in the coming quarters to support demand.

Sales into the VIA markets remain healthy in the December quarter following two quarters of rapid growth and near record revenue in September. We project a seasonal slowdown in the VIA market during the March quarter, but expect revenue to remain up on a year-over-year basis.

Within the legacy market, revenue came in at $775 million, down 7% sequentially and 15% year-over-year. Seasonal demand for consumer drives partially offset weaker-than-anticipated PC sales due in part to ongoing PC component shortages and lower mission critical sales.

As we discussed last quarter, component shortages are also impacting sales in our system business, as customers delay some of their product deals due to constrained supply of non-drive components. Despite this headwind, non-HDD revenue increased 17% sequentially and 48% year-over-year to a record $294 million, boosted by strong SSD demand. While we continue to face near-term supply challenges for both the system and SSD businesses, we remain confident in growing the non-HDD business in fiscal 2022, particularly for our system solution where we see ongoing demand and continue to capture new customer logos.

Looking at our operational performance, non-GAAP gross profit in the December quarter was $958 million. Our corresponding non-GAAP gross margin was 30.7%, down 30 basis points sequentially, but up nearly 400 basis points year-over-year. The ongoing transition to both higher capacity drives and cost optimized product mostly offset higher freight and logistic costs in the less favorable product mix with record non-HDD sales.

Notably, HDD gross margin remain in the upper half of our long-term target range of 30% to 33%, flat with the prior quarter. We maintain relatively flat non-GAAP operating expenses at $337 million, lower than expected, reflecting our disciplined expense management and the timing of certain spending. We expect OpEx to be somewhat higher in the March quarter due to an increased R&D expenses and business travel.

Our resulting non-GAAP operating income was $621 million, down 1% sequentially and up 61% year-on-year. Non-GAAP operating margin remained relatively flat with the prior quarter at 19.9% and at the top end of our long-term target range of 15% to 20% of revenue. Based on diluted share count of approximately 225 million shares non-GAAP EPS for the December quarter was $2.41, which is $0.06 above our guidance midpoint.

We increased inventory by approximately $100 million, with days inventory outstanding of 54 days to support the upcoming 20-terabyte product ramp. Capital expenditures were $95 million for the quarter, down 19% sequentially. For fiscal 2022, we continue to forecast CapEx at the low end of our target range of 4% to 6% of revenue, which is sufficient to support our future product roadmap while maintaining alignment between near-term supply and demand. Free cash flow generation increased to $426 million, up 12% quarter-over-quarter and 36% year-over-year. We delivered strong performance in the December quarter, and expect to improve free cash flow generation through the fiscal year, enabling us to continue to fund our strong capital return program.

In the December quarter, we used $151 million for the quarterly dividend and $471 million to repurchase 5.1 million ordinary shares, exiting the quarter with 219 million shares outstanding, and approximately $3.3 billion remaining in our authorization. We ended the December quarter with cash and cash equivalents of $1.5 billion, and total liquidity was approximately $3.3 billion including our revolving credit facility. Adjusted EBITDA increased to $723 million in the quarter, our highest level in seven years, and was $2.6 billion for the 12 months' period ending in December. Total debt balance at the end of the quarter was $5.9 billion. And as we previously reported, we plan to repay $220 million in debt coming due in March.

In summary, we delivered solid financial performance, maintaining our focus on driving profitability and free cash flow generation while navigating a dynamic business environment. Looking ahead to the March quarter, we expect a continuation of the healthy demand environment in the nearline market, with anticipated seasonal decline in VIA and the legacy markets.

As Dave noted, we are mindful of the ongoing impact related to COVID dynamics, and we'll continue to manage through supply chain constrain and other inflationary pressure, but we expect to persist through at least the fiscal year. We expect March quarter revenue to be in the range of $2.9 billion, plus or minus $150 million. We expect our operating margin to be impacted by COVID-related pressure, which I just discussed over the near term; however, we believe that structural changes in the industry, combined with Seagate disciplined execution, will support a higher operating margin over time. As a result, we're raising our long-term target non-GAAP operating margin range to 18% to 22% of revenue compared with our prior range of 15% to 20% of revenue. With that in mind, we expect our March quarter non-GAAP operating margin to be at the lower end of our revised long-term range of 18% to 22% of revenue. And finally, we expect non-GAAP EPS to be in the range of $2, plus or minus $0.20.

Looking further ahead, ongoing demand for mass capacity storage, combined with our strong product pipeline, give us confidence to further raise our fiscal year 2022 revenue growth to be between 12% and 14%, up from our prior outlook in the low double-digit range.

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

William David Mosley

Chief Executive Officer & Director, Seagate Technology Holdings Plc

Thanks, Gianluca. I'm very proud of the results Seagate posted in the December quarter and also our ability to deliver consistent performance during this unique period of transitory issues. Through it all, the trends driving

explosive growth in data remained powerful, longer-term demand tailwinds that will push growth in mass capacity storage in 2022 and for years to come.

Seagate has the right product portfolio, operational know-how and partnership focus to capture these opportunities and lend confidence in our ability to deliver on the annual growth targets we've outlined today, as well as achieve strong profitability and cash generation to fund our robust capital returns program.

Seagate has been a technology company innovation leader for over four decades. We are now leading the industry into a new era of technology with HAMR and multi actuator drives. The industry has undergone a positive structural change with the transition of mass capacity markets. These innovations are the results of years of intense focus and significant investment that bring value to our customers and to their customers by unlocking the power of their data. We're focused on capturing an appropriate return to continue fueling our mass capacity innovation engine, which we believe is healthy for Seagate and for the industry at large.

In closing, I would like to thank our employees who deserve the credit for Seagate's outstanding performance this past year. We are a values-driven company, and last week we published our third annual diversity, equity, and inclusion report that captures the many ways we put our value of inclusion into action

Among the many positive measures in the report, I want to highlight an increase in the overall percentage of women in Director and Executive roles, as well as an increase in minorities in our US workforce. These are important areas of focus for the company and reflect positive progress on our efforts to build a more global, diverse and inclusive workforce, which we believe leads to better business sustainability. I would also like to thank our customers and suppliers for their continued support, and our shareholders for their trust in Seagate.

Gianluca and I are now happy to take your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from Wamsi Mohan with Bank of America. Your line is open.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Hi. Yes. Dave, can you hear me?

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

A

Yeah, I can you hear you, Wamsi.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Okay, great. Dave, when you look at the gross margins coming in slightly down quarter-on-quarter, can you talk about the moving pieces there just in terms of price versus the inflationary pressures that we have seen over the last few quarters? You guys have done a great job on a year-on-year basis, but how should investors think through these moving pieces over the next few quarters?

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

A

I appreciate the question. We've tried hard, as you know, to be as predictable as we can. There are a lot of near-term margin headwinds that we described in the prepared remarks, and we still remain focused on being as prescriptive as we can over time. We don't view that our current range is some kind of ceiling or anything like that, but there are near-term headwinds, and I'll ask Gianluca to illustrate with the few numbers here in just a second.

Big picture, what's going on in our industry is our drives have been getting more and more mass capacity, of course, and which means inside the drive there is more heads, more disks all the time. So, I think for the last quarter it grew yet again and it probably will for the course of the next few years also. And so, as we do that, these are long-term investments in factories and the entire supply chain around heads and media, those constituents of the BOM become more under our control, and I think it allows us to go drive for a little bit more predictable return on investment, but obviously this is a challenging period.

So, Gianluca, you want to highlight some of the challenges?

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

A

Yeah. I would say, first of all, the change quarter-over-quarter is mainly coming from mix. If you look at the hard disk drive, gross margin is completely flat to the prior quarter, so we don't have any change in profitability for the hard disk. We have increased a lot our non-hard disk revenue, mainly in the SSD part of the business, and that is driving some reduction in the overall gross margin but, of course, was also very helpful at the revenue level and the free cash flow level.

Now, when you look inside the hard disk, mass capacity was at a record high. Fairly close to September, as we were expecting, about 1% higher, but still a good record high. Legacy was sequentially down in mission critical, but as you know is a high gross margin segment and was actually higher in consumers that is actually a lower gross margin segment. So, there is a lot of mix going on into December, but finally the reality is hard disk, in total, was flat gross margin compared to September, and the increase in the non-hard disk part was driving the slight decline at the company level.

Now, when you go into the March quarter, when still mix impact is a different kind of mix. This is more a seasonality impact. Some of the segments that will be seasonally low are fairly high gross margin like surveillance, like mission critical. Other segments are actually fairly, let's say, not low but lower gross margin like consumer, and we also expect at this point some decline in the SSD part of the revenue.

So, when you put all together, again the mix is probably driving a gross margin in the March quarter slightly down from the December quarter, but it's not coming from the business, it's coming mainly from the mix.

As Dave was saying before, of course, we have also some cost increases mainly in the freight and logistic costs. We saw it two quarters ago to be already at a high level of the freight cost, but it continued to increase in September and again in December. This we expect to start declining in the next few months, but with our spending control, with the strong mass capacity business that we have, we have mainly offset those bad news coming from the cost, leaving the mix impact, of course, impacting the total result.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Okay, that's great. Thanks a lot for all the color.

Operator: Your next question comes from the line of Karl Ackerman with Cowen and Company. Your line is open.

Karl Ackerman
Analyst, Cowen and Company, LLC

Q

Yes. Thank you. Two questions, if I may. One is a follow-up to Wamsi's most recent question, but Gianluca, you spoke about non-HDD component shortages disrupting some of your enterprise customers' shipment plans. If I may, are you referring to mission critical here or is this weighted toward mass capacity? And I have a follow-up.

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

A

No, I would say the shortages we have experienced in two parts of the business, one is the PC and one is the system solution.

Karl Ackerman
Analyst, Cowen and Company, LLC

Q

Understood. That's clear.

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

A

So, I think to break it down a little bit, Karl, there is some mission critical and there is some nearline components to that if that makes sense.

Karl Ackerman
Analyst, Cowen and Company, LLC
Q

Great. I guess, from an end demand perspective, to me it sounds like most end markets may moderate in March except for the nearline hard drives, but I was hoping you could discuss the visibility you have across your data center customers today for high-capacity drives which some of these customers are signing long-term agreements. And then, second, just the visibility in the trajectory you have for the remaining areas of your business as you contemplate that 3% to 6% growth for calendar 2022. Thank you.

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

Great. Good. So, as we said in the prepared remarks, the 20-terabyte demand is quite strong and so we're using this period, this quarter, to transition between whatever components that are flowing through that are 18-terabyte specific. There aren't very many because it's a leveraged platform to the 20 terabytes and really gets staged for high growth on the 20 terabytes, and the visibility is very good for those products. I think the customer demand has been – the customers are quite receptive to that. They see a TCO benefit.

On all of the other markets, we continue to watch and forecast and have – in some cases, we have very deep relationships with the customers that can help also provide some level of confidence there as well. So, in aggregate, I think it's going to be very strong year for exabytes as well, and we'll translate that into revenue. There are some temporary problems that are going on right now because of supply chain issues that are affecting everyone. It's more affecting our demand than it is our supply, but we're mindful of that and paying attention to it. I think the demand picture for mass capacity data, in particular, remains strong.

Karl Ackerman
Analyst, Cowen and Company, LLC
Q

Helpful. Thank you.

Operator: Your next question comes from the line of Tim Arcuri with UBS. Your line is open.

Jason Park
Analyst, UBS
Q

Thanks a lot. This is Jason Park, on for Tim Arcuri. Our first question is, how can we think about the June quarter if June is close to normal seasonal, which is usually flat or up a little, then the implied second half of the calendar year has been pretty strong, like 53% of the year, which is about the strongest second half of the calendar year loading we have seen. So, just wanted to ask, what are the drivers there and what gives you the confidence? Then I've got a quick follow-up.

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

Right. I think you're on the right point which is, so if you look at the tail of the tape, we go back to when we entered this calendar year, we were talking about low – or sorry – high single digits for revenue, and then we said may be low double-digit. Now, in these remarks, we said 12% to 14%, and we're already more than halfway through the fiscal year. So, exactly you can start to look at Q4 and see that we are right now forecasting strength,

some of that's coming on the back of the 20 terabytes that I've just talked about to the response to Karl, some of it's also the transition to the cost optimized drives that we made reference to as we transition to that platform.

All the way from 2 terabytes, 8 terabytes, 10 terabytes, we can actually predict that market pretty well and have great conversations with customers there as well. So, we feel fairly comfortable with that part of the guide. And then we talked about the entire calendar year as well as growing on top of last calendar year, so it's all baked into our forecast.

Jason Park
Analyst, UBS

Q

Got it. And my follow-up question is on the demand in China. So, we just wanted to gauge your level of concerns in China as we think most of the nearline business is direct rather than through a channel, but there are a lot of concerns about demand weakness there due to some of the government restrictions. So, my question is, what are you seeing from the hyperscalers in particular in China? Thank you.

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

A

There have been pockets of buildout that's been pushed out largely because of other supply chain issues, not necessarily mass capacity issues. I think those investments are still planned. Now, some of that pushout may be happening because of component shortages, it may also be happening because of prioritization of budgets into COVID measures or other things that the end customer is actually prioritizing, but we're not really that worried about it long term. We have great relationships with the OEMs and I think – and the cloud service providers then I think, long term, I think these continued buildouts are going to come, not just in China but I would say for all of Asia there's a lot of new applications that are coming online, a lot of smart city applications. We're quite excited about it. So, we see that's all baked into our revenue forecast that we just gave.

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

A

Yeah. I think we need to be careful on not confusing seasonality with lower demand. So, when we're going through the March quarter, our mass capacity – part of our mass capacity will be impacted by seasonality, especially in the surveillance part of the business, but that is not because a high level of inventory or unusual lower level of demand. It's the normal seasonality that we expect for that segment in the March quarter. And then the June quarter usually start to improve and get very strong in September and December.

Jason Park
Analyst, UBS

Q

Thank you so much.

Operator: Your next question comes from the line of Tom O'Malley with Barclays. Your line is open.

Thomas O'Malley
Analyst, Barclays Capital, Inc.

Q

Hey, good afternoon, and thanks for taking my question. My question was related to the VIA business. You're describing some seasonality into March, but you made the comment on the call that from a revenue basis it would be up year-over-year. Obviously, when you look at exabytes, March was extremely low for the business in terms of exabyte shipments in VIA. Can you just try to dial us in a little bit between those two field goal posts there?

When you look at what is traditional seasonality into that March quarter, what should that look like just because it's hard to get engage given how weak March of 2021 was?

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

A

That's a great point. As we compare back to a year ago when I think anybody trying to forecast off of the pandemic kind of investment behaviors is going to be challenged. So, I would say that the strength in smart city applications that are coming online. In Q2, things could have been even a little bit better. It was clearly better year-over-year, but could have been even a little bit better.

I think to the earlier question, there are reasons to believe that some of those buildouts are getting pushed out. And, unfortunately, the COVID pandemic is still with us and some of those priorities are still being made this quarter. We do forecast, over time, that the market should strengthen, and we talked about mid single-digit – or sorry – mid double-digit growth in the VIA markets. I think it all depends on applications and then the economics with the investments that will have to be made across the breadth of the component supply chain.

From our perspective, the demand for data products is quite strong in these markets, and so we should still see that growth and maybe even more as time goes on.

Thomas O'Malley
Analyst, Barclays Capital, Inc.

Q

Okay. Then my follow-up was just on the inventory side. There's obviously an uptick. You mentioned in your prepared remarks that that was mostly related to a buildup in 2020. Are there other parts of that inventory that are climbing just because of the supply dynamics of the market where you're not shipping product? I think you mentioned also that some of that was actually demand-related, and that could be because of componentry, et cetera, but can you just dive into that inventory number? Is it all the increase due to 20T or is there some other pieces in there as well that will help us understand?

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

A

Largely, it's the 20T. We're able to use those parts against a broader portfolio than just 20Ts, of course, we can go to 18Ts, 16Ts, or all the way. Like we talked about, some of the components are very, very similar down even further so at the end of the cost optimize drives. So, that's the way we think about it, is that, yeah, there is some inventory buildup going on right now, some of that's staging for bigger growth in subsequent quarters after this quarter. And the components are very usable across multiple families. We're not really worried about the growth.

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

A

In the last few quarters, we have made some strategic inventory, of course, to be a little bit protected by this supply chain situation, but not much in the December quarter, so I would say we have done it before. The increase that you are seeing in the last three months is mainly related to the 20-terabyte ramp.

Thomas O'Malley
Analyst, Barclays Capital, Inc.

Q

Thank you.

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

Katy L. Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Yes, thank you, good afternoon. March quarter revenue is typically down mid-to-high single digits, which aligns perfectly with your guidance. In your prepared remarks, you did mention that supply pressures could put some additional pressure, and I wasn't sure whether that could be incremental to downside of the revenue guidance or if that's something that you had baked in for the March quarter. And then just connected to that, the implied June revenue looks to be better than seasonal, up sort of 2% to 3%. Is that because you would expect some of these supply headwinds to either to resolve themselves as you go into June? And then I have a follow-up? Thank you.

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

A

Yeah. Thanks, Katy. There are a number of different dynamics, and I think the latter part of your question, first, yes, there are components that we feel will break free in the next few weeks. And so – and yes, we've have tried to bake that into our guide as much as we can for this quarter. There are some components that won't break free for quite some time, and you have to make sure that you're staging those loads into your build plans. That goes maybe for our builds, but we're also trying to look at the broader tech ecosystem because we do know that there are customers. Generally speaking, they're the smaller customers, but they've had trouble getting some of these complete kits.

And so all of this is tough for the customers right now. We're just trying mainly to help them get through the period. There are some things that will get better near term, and there are some other things that are going to stay for a little bit longer.

Katy L. Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Okay, that's helpful. And then maybe, Gianluca, if you can extend the discussion you had with Wamsi on gross margin into how we should think about the March quarter. Your revenue and EPS guide is really in line with consensus, but on the gross margin line consensus was thinking you could hit north of 31%, which would be an improvement. Do you see the mix shift back towards HDDs helping you expand gross margin sequentially in March?

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

A

Well, in March the main impact will be coming from the mix, and surveillance, VIA market in general is a very high gross margin segment. So, we will have some impact from that business declining and also mission-critical. So, when we look at seasonality and look at the segments that are really impacted, are segments that are fairly high gross margin. Of course, the continue increase in our mass capacity so in the cloud, in the nearline, and then the OEM part of the nearline. That is all positive.

And I think we will continue to see improvement in our gross margin after the March quarter when we go into a less seasonal part of the business and, of course, even stronger when you go into September and December. So there is an impact that is due to seasonality and is normal for this industry. I will not look that as unexpected.

Katy L. Huberty
Analyst, Morgan Stanley & Co. LLC

Q

So gross margin sort of flat to down in March seasonally and then improvement off of that base?

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

Yeah, this is how we guided, yes.

Katy L. Huberty
Analyst, Morgan Stanley & Co. LLC
Q

Okay.

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

The best way that can drive gross margins is to continue the transition of more mass capacity products to get more constituents of the BOM into the drives that are heads and media.

Katy L. Huberty
Analyst, Morgan Stanley & Co. LLC
Q

All right, perfect. Thank you so much.

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

Mark Miller
Analyst, The Benchmark Co. LLC
Q

Thank you for the question. Just was wondering, you mentioned some of your nearline people will be facing some supply constraints. What about your own supply of chips, is that holding up?

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

Yeah. I think we have deep partnerships with our suppliers, been with them for a long time. I think there are a lot of dynamics that smaller customers have that we try to help them with. And then from my perspective, there's certain amount of volatility with that. But like I said before, stuff is becoming more predictable over time even if it might not be at the level what some of those customers want. So we're getting better visibility I think as time progresses.

Mark Miller
Analyst, The Benchmark Co. LLC
Q

Is there anything – you mentioned SSD sales, anything else driving your other sales in terms of enterprise that's been very strong growth over the last year?

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

I do think there is demand for data out there on-prem and some of that is probably not being serviced, I mean, as well as they could be if there weren't some of the supply constraints, Mark. Yeah, I think there is probably some underserved demand but it may be part of other build-outs as well. They may have a problem getting compute or

they may have problem getting network so they don't do the entire build-out. And I think this is going to shake out over the next few months.

Mark Miller
Analyst, The Benchmark Co. LLC

Q

Thank you.

Operator: Next question comes from Mehdi Hosseini with SIG. Your line is open.

Mehdi Hosseini
Analyst, Susquehanna International Group, LLP

Q

Yes, thanks for taking my question. I want to get your thoughts on nearline mix expectation for 2022 and on how we should think about the migration from 16 to 18 and then to 20 terabyte especially given your commentary that was focused on 20 terabyte and I have a follow-up.

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

A

Yeah, maybe, we're largely transitioned to the platform that can actually give 18s or 20s if we wanted to back to 16s, if we wanted to. So, we mix according to what the customer demand is, we don't really build a theoretical mix. So, we're talking to customers. Some people aren't ready for transition to 20s, some people want to stay on 18 terabyte, some people want to stay on 16 terabyte. So, we're here to serve them. The fact that we have these new platforms, part of the – whatever changes, tweaks or works to this common platform will actually put us in a little bit better cost position.

And I would say relative to the aggressive ramp that we've made – we referenced in our prepared remarks, you know the 20-terabyte ramp is going to be very, very aggressive ramp. So, that's what we're staging for in this quarter, last quarter and this quarter. But that'll be transitioning over to the next – over the course of this calendar year to higher and higher volumes.

Mehdi Hosseini
Analyst, Susquehanna International Group, LLP

Q

Got it. And then just going back to the gross margin topic, I understand the mix impact. You also highlighted material cost that has gone up and I want to better understand how you're able to pass on that incremental cost to your customer. Would it be fair to say that there is a really unusual pricing dynamic for different products and in that context, would you be able to pass on that incremental cost increase to customers?

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

A

Yeah. To be specific most of the cost increases that we saw, not all, but most of them are freight and logistics related especially when we don't – or the customers don't predict demand perfectly. And again, this is a very hard – difficult world to get the right kits in the right place at the right time and everybody is trying. And then you have to pay the freight and logistics fees to get the stuff there as quickly as possible, that becomes problematic.

We don't necessarily look first to pass that along. We work with our customers who are supply chain experts themselves to find ways to mitigate those costs because everybody really wants that – that's in the spirit of partnership of up and down the supply chain. There may be places where we will ultimately have to pass those

costs along and that will – there's a time lag associated with that of course as we run the plays that we have. But from my perspective, we have deep discussions with our customers on this. They understand and in some cases they run massive supply chains themselves. They understand exactly what's going on, so we work together with them on it.

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

A

Yeah. I'll say the favorable price environment is mainly related to the good alignment between supply and demand, not too much on transferring of cost from a supplier to the customer.

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

A

Right. Most of [indiscernible] (46:57) heads and media for mass capacity now, there're really long lead investment cycles and things like that. So, that's – that we're focused on.

Mehdi Hosseini
Analyst, Susquehanna International Group, LLP

Q

Got it, thank you.

Operator: Your next question comes from the line of Sidney Ho with Deutsche Bank. Your line is open.

Q

Hi, this is [indiscernible] (47:18) on for Sid. How should we think about trajectory of operating expenses as we go through calendar year 2022? I would assume you will see an uptick in travel and labor cost but perhaps a decline in some COVID safety costs.

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

A

Yeah. It's a good question. I would say, in the December quarter, OpEx came out a little bit lower than what we were expecting. Part of the reason is exactly what you are saying. We were not expecting a resurge of the COVID situation. So, our travel was kind of limited again in the December quarter. We think that now – this situation will start to improve possibly already in the March quarter and in the following quarters. So, probably our OpEx will increase a little bit through the calendar year, still in the range that we discussed last quarter between the $340 million and $350 million per quarter. This is, right now, what we expect.

Q

Great. And then, on the nearline side, how do you think about your gross margins of your higher capacity drives as you continue to increase capacity? Should the 20-terabyte have a similar gross margin profile to the 18-terabyte when fully ramped?

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

A

Yeah. I think there is opportunities, of course, to increase as we introduce any new technology node whether it's 20 terabytes or the generations that come after it. A lot of that comes down to how fast can we get up the media and head yield curves and where our scrap builds are and things like that. They're firmly under our control. So, we transition according to what customers need. We transition according to how fast we can based on all of our internal metrics as well and so I think there is an opportunity to build that over time.

Q

Great, thank you.

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

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Hi. Good afternoon, guys. Appreciate you taking the questions. Yeah. Two quick ones if I could, I guess, one for each of you. Dave, any change over the last 90 days in your perspective on sort of nearline demand either in terms of – and you guys gave a growth outlook. But I guess either in terms of length of cycle or [ph] punch (49:48) of cycle, would love any context there and then just a quick follow-up.

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

A

Ananda, against the big backdrop I think no. Going – at the start of the pandemic, we knew that work from home and a bunch of the challenges that people had, getting IT professionals to work on on-prem solutions, all that meant people pushed into the cloud. The cloud is growing faster than we thought because of a lot of that push I think and it's not just storage. Of course there is compute and there is network and there is other parts that are really stressing those businesses as well. But the storage will come, and so we think it's been fairly predictable in the conversations with our customers about what kind of build-outs we want to do.

And we think there's more opportunities because the value of the data just gets better and better. So, there hasn't – even though there are temporary supply chain problems for a lot of people out there, I don't think there's been any real significant change shift in the mass capacity demand.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Okay. That's super helpful. And then, I guess, the follow-up is for Gianluca. Gianluca, you sort of made mention briefly of ASPs a few months ago. Like, can you just describe to us how you view ASPs? And you had mentioned sort of pretty aligned supply/demand. Could you also just sneak in some context about your capacity situation and do you need to put on more capacity to meet the demand as you go through the year? And that's it for me. Thanks.

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

A

Yes, Ananda. As you know, we are spending a relevant amount of CapEx every quarter. So, the fact that the supply and demand are now very well aligned is not because we're not investing, it is because demand is strong and we put in place the capacity that is needed and try not to put more than what is requested. Of course, because there is some seasonality through the year, there are quarter where that capacity is not exactly matching

demand. But, in general, part of our job is to estimate demand and define what is the CapEx that is needed to match the demand and satisfy our customer demand without putting capacity that is not needed. That is the main driver for the pricing.

And now in the last several quarters, as we have seen, the pricing environment has been much better than over a year ago, two years ago, and we think that the industry deserve an appropriate return for all the significant investment that we are making and the industry in general is making, and all the value that we deliver to support the mass capacity growth. And this is what we are striving for.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Thank you. That's great. Thanks a lot you guys. I appreciate it.

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

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

Q

Thank you very much. Dave, maybe first off, seems like you're getting really good traction and adoption for the 20-terabyte drives over the next few quarters. Can you give us your thoughts on the HAMR drive, whether the common platform could potentially delay adoption of HAMR or is that still on track? And how is customer acceptance of the next generation HAMR drives?

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

A

Yeah, thanks. So, the HAMR has always been planned to go into the common platform. There will have to be some changes specifically for that. Exactly to your point, we plan to continue to do customer eval so that the customers know exactly what kind of behaviors they'll get. They'll be higher capacity drives when they ultimately come with HAMR too. Very happy with the progress actually on HAMR. So I think we said a couple quarters ago, this is happening right now. We are in the intense product development, engaging with customers, they're partnering with us on it.

As far as transition goes exactly to your point, a lot of people know fabs. They know that you have to take some stuff offline to replace it with other stuff and we'll do that as we see the yields come up and the opportunity there. We have to work with the customers as well on their adoption profiles but we're in the middle of all those discussions right now.

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

Q

Great. And my follow-up question maybe for Gianluca in terms of the investments into the company, you've obviously invested a lot into HAMR and the common platform. Can you discuss some of the investments maybe on a big picture basis for stuff like your Lyve platform? How much investments are needed to kind of build up that business, additional solutions offerings that'll come out of that platform over time? How much more do you need to invest as it relates to Lyve? Thank you.

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

A

It is a very good question. The Lyve business is mainly based on hard disk. It is a cloud storage that is based on hard disk. So it's not really requiring a lot of additional CapEx. It's part of what we used for our normal production that we know depending from demand we move between customer location and the internal need.

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

A

Yeah. These aren't big investments, Patrick. But what I would say is that we constantly look for ways that we can develop go-to-market chains in particular that can use the products that we're making into – in different ways. So think circularity and recycling product and having outlets for product. There is a lot of opportunities that we have in our systems business and also inside of the Lyve platform. And we think about this as a way to help us not only construct channels that are economic, great benefit to customers, but also ultimately help us manage the panoply of different parts issues that we're going to see in the world given our scale.

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

Q

Thank you.

Operator: Your final question comes from the line of Jim Suva with Citigroup. Your line is open.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you for fitting me in. My question is on pricing of your products. It seems like the past, geez, must've been two years has been much stronger than historical precedent for pricing. Do you foresee that happening how much longer? Because you mentioned some of your components are going to be freed up here in the next few weeks and you mentioned some others are going to be elongated. So, I'm just wondering for pricing, how long do you think we'll be in this environment of much more historically stronger than what normal is? Thank you.

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

A

Right, Jim. I think it's right to point out that if you look back 5 or 10 years ago when we had so many client server drives that were in our factories, very different environment than when you have mass capacity with really long lead times and things like that. So, as we've transitioned over the last couple of years to the mass capacity then we can actually say these are the investments we're making, these are the starts we're doing, and we can get working on long-term agreements and just predictability within the market in that.

Of course, there can always be some disruption to the extent that there are more and more heads and media related that's under our control. If there are external piece parts than like COVID has affected quite a number of suppliers of ours but also customers and end markets. That's where things get a little bit more volatile. But I think if you – from my perspective, generally speaking, as we go to more and more mass capacity drives, as the drives have more heads and media in them, then things get a little bit more predictable because we have to get the return on investment.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you so much, it's greatly appreciated.

Operator: There are no further questions at this time. I will now turn the call back over to management for closing remarks.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Holdings Plc

Thanks Brent. As you can all see, calendar 2022 is an outstanding year for Seagate and we believe that our strong product and technology roadmap combined with our ongoing solid execution positions us well to capture secular growth opportunities for mass data infrastructure for years to come. I'd just like to once again thank our employees for their outstanding efforts and our customers and suppliers and investors for their continued support for Seagate. Thanks for joining us today.

Operator: Ladies and gentlemen, thank you for your participation. This concludes today's conference call. You may now disconnect.