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Seagate Technology Plc (STX)

Q2 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good Morning, and welcome to the Seagate Technology Fiscal Second Quarter 2020 Financial Results Conference Call. My name is Josh and I will be your coordinator for today. At this time, all participants are in a listen-only mode. [Operator Instructions]

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 December 2019 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 March quarter financial outlook and expectations about our financial

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performance, market demand, industry growth trends, planned product introductions, ability to ramp production, future growth opportunities, 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 the supplemental information posted on the Investors section of our website. Following our prepared remarks, we'll open the call for questions.

And 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'll begin today's call by highlighting a few key accomplishments for the December quarter and then I'll share some perspectives on the market trends and their relevance to Seagate. Afterwards, I'll turn the call over to Gianluca to elaborate on our December quarter financial performance and present our March quarter outlook. Following the prepared remarks, we will open up the call for questions.

In the December quarter, we grew revenue to $2.7 billion and drove strong double-digit profit growth on a sequential basis, with both non-GAAP operating margin and non-GAAP EPS coming in at the upper end of our guided ranges. Importantly, we have generated nearly $1.2 billion in free cash flow over the past 12 months, underscoring our consistent operational execution.

In addition to delivering solid financial results, we achieved record exabyte shipments in the December quarter, supported by strong demand for mass capacity storage and the continued successful ramp of our 16-terabyte products. Consistent with our expectations, we shipped 1 million 16-terabyte drives during the quarter to support strong customer demand. We also strengthened our product portfolio announcing Seagate Lyve Drive Mobile System, a series of seamlessly integrated storage solutions to address the burgeoning need to move data between endpoints, edge, and core cloud environments in an efficient, secure and cost-effective way. Lyve Drive was one of many products we showcased during the Consumer Electronics Show this past January, which I'll discuss shortly.

First, let me comment on some of the trends we're seeing in the market. Our December quarter results highlight the increasing demand for mass capacity storage, which includes nearline, video and image applications and network-attached storage or NAS. Revenue from mass capacity storage increased 9% quarter-over-quarter and 25% year-over-year driven by growth across each of these markets. This positive trajectory reflects both ongoing demand recovery as well as secular growth for mass capacity storage.

In nearline, we are leading the industry's transition to 16 terabytes, which is the largest capacity drive available in mass volume today offering the best total cost of ownership opportunity for our customers. In the December quarter, these products represented the highest revenue and highest exabyte shipments of any of our drives. We achieved these results while still at the very early stages of this industry transition.

Nearline demand has been on a positive trajectory that we expect will continue through at least the rest of the fiscal year. We are well positioned to address this growing demand as we continue to ramp our 16-terabyte production and launch our 18-terabyte drives, which are based on the same platform, simplifying the manufacturing and qualification processes. The 18-terabyte launch is progressing to plan and we remain on track

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to begin shipments in the first half of the calendar year 2020. We expect to align our production to meet customers' demand.

In video and image applications, we achieved record revenue in the December quarter driven by strong demand for surveillance drives. As we've shared for multiple quarters now, global uncertainty has created some disruption in typical customer buying patterns within certain markets, including surveillance. However, the underlying demand drivers remain intact and inventory levels appear to be relatively healthy, supporting our positive view of demand over the long term.

Security surveillance is just one of a growing number of applications adopting high-definition video and image processing, which require mass capacity storage at the edge and in the cloud.

A few weeks ago at CES, we demonstrated how video and imaging sensors are being deployed in smart cities and smart factories to collect and analyze massive amounts of data used to improve traffic flow, hasten emergency response times, lower production costs, and improve worker safety. These are real-world use cases spawned by the emergence of IT 4.0, which illustrate how organizations are unlocking value from the data being created by sensors, cameras and other endpoint devices.

The transition to IT 4.0 and trend towards a multi-cloud world create meaningful opportunities for Seagate. We project a typical smart factory can create 5 petabytes of video per day and a smart city could generate 200 petabytes each day. To fully realize the data potential, compute and storage must move closer to the source of the creation, closer to the edge.

At CES, we also showcased how Seagate storage solutions are enabling IT 4.0 and hybrid cloud environments by leveraging our innovative technologies and expertise in systems architectures. We featured our high-density scalable systems, which offer enterprise customers a cost-effective petabyte solution ideal for data-rich cloud applications. The unit we displayed at CES was configured with 106 HDDs, including multiple HAMR drives working in real time. We are on track to release the industry's first commercially available HAMR drives in late calendar 2020 at the 20-terabyte capacity point.

Each year, I look forward to the Consumer Electronics Show for the opportunity to interact directly with customers, partners, suppliers and loyal enthusiasts of Seagate products to hear their feedback firsthand. The consumer market remains a very good business for Seagate. In fact, in the December quarter alone, we shipped 12 exabytes in portable external drives trusted by our user community to move their data.

To media and the entertainment professionals, gamers, and prosumers, the Seagate brand of storage solutions represents quality, reliability and simplicity. We designed our Lyve Drive mobile solutions with these same principles in mind. As I mentioned earlier, Lyve Drive offers enterprise CIOs a solution for efficiently and cost effectively managing data between endpoints, edge and core cloud.

Even with a dedicated 10-gigabit-per-second connection, it would take at least 12 days to upload a petabyte of data to the cloud. The cost for sending large amounts of data over a network can be in order of magnitude more expensive than simply physically transporting it. With Lyve Drive, customers can securely transport data and ingest it into their data centers more quickly and affordably than other available options. Our integrated approach is a first key step towards a unified data experience.

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Overall, we are excited by the momentum of our 16-terabyte drives, the competitive strength of our technology roadmap and the breadth of our product portfolio, all of which we believe position Seagate well to address the growing demand for mass capacity storage and need for data management solutions.

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

Gianluca Romano

Chief Financial Officer & Executive Vice President, Seagate Technology Plc

Thank you, Dave. The December quarter represented another period of solid financial performance and strong free cash flow. On a sequential basis, revenue increased 5% to $2.7 billion. Non-GAAP operating income increased 29%, translating to non-GAAP operating margin of nearly 16% of revenue. And non-GAAP earning per share increased 31% to $1.35. Our results demonstrate strong operating leverage supported by ongoing expense discipline and a richer revenue mix of mass capacity storage.

Mass capacity storage, which include nearline, video, and image application and NAS drives, represented 49% of total December quarter revenue, up from 47% in the prior quarter and 39% in the prior year. Exabyte shipments into this market increased 12% sequentially to 71 exabytes. This strong sequential growth was underpinned by demand for our mass capacity drives. As we shared during our analyst event, we expect that mass capacity revenue will continue to grow quickly over the next several years. Our product portfolio and technology roadmap are well aligned to capture these growth opportunities.

Revenue from 16-terabyte drives nearly tripled quarter-over-quarter, making them our highest revenue product during the quarter, a trend we expect to persist through the rest of the fiscal year as we continue to ramp this product to support a broadening of customer demand.

Increased demand for mid-capacity nearline drives was another highlight for the quarter. Sales of our 4-, 6- and 8-terabyte drives moved higher to support enterprise and OEM customers as they build out their on-prem and private cloud storage needs.

Our cost-reduced mid-capacity products continue to gain momentum, offering customers a better TCO relative to prior-generation products. In addition to healthy nearline demand, we also realized double-digit revenue and exabyte growth for video and image applications, reflecting above seasonal demand, which we expect to normalize moving into the second half of the fiscal year.

As Dave shared earlier, with the advent of IT 4.0 and the adoption of video and image sensor across the growing number of applications, we foresee meaningful growth opportunity for our mass capacity storage solution in this market. Revenue from the legacy market remained fairly flat on a sequential basis and represented 43% of December quarter revenue compared with 46% in the September quarter.

Exabyte shipment into the legacy market increased 3% sequentially to 36 exabytes. We continue to garner customer and consumer support for our legacy products, which include mission critical, desktop, notebook, DVR and external consumer drives. Seasonal demand for consumer drives, combined with higher mission-critical sales, largely offset the expected decline in gaming console and notebook.

Overall, our total HDD average capacity per drive increased 11% sequentially, and we expect average drive capacity to further increase as demand for mass capacity storage continue to grow. The remaining 8% of

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December quarter revenue was derived from our non-HDD business, in which revenue increased 14% sequentially, driven by growth in both systems and SSD.

We are continuing to build momentum with our system solution driven by increasing demand for data at the edge and the adoption of private cloud. Enterprise customers are seeking denser storage solution driving higher system content. This dynamic supported a new exabyte shipment record for systems in the December quarter.

Non-GAAP gross margin was 28.7%, up 200 basis points sequentially, reflecting a more favorable product mix with a higher contribution from mass capacity drives. Non-GAAP operating expenses were $350 million, down 3% sequentially and slightly below our prior estimates due mainly to lower discretionary spending. We are evaluating opportunities to drive further operational efficiencies while continuing to invest in areas that support future growth.

Through the combination of higher gross margin and controlled spending, we delivered non-GAAP operating income of $424 million, up 29% quarter-over-quarter. This translates to non-GAAP operating margin of approximately 16% of revenue, at the top end of our long-term financial model range. Based on a share count of approximately 265 million shares, non-GAAP EPS for the December quarter was $1.35, which surpassed our guidance midpoint. Consistent with our expectations, capital expenditure increased to $194 million to support growing demand for mass capacity storage. We project fiscal year CapEx to be towards the middle of our long-term range of 6% to 8% of revenue.

We generated strong free cash flow in the December quarter, fairly stable with the past several quarters, and we continue to deploy capital to reward shareholders through our long-standing capital return program. We utilized $150 million to retire 2.5 million ordinary shares, exiting the quarter with 261 million share outstanding, and we used $165 million to fund our dividend. Our board also approved a quarterly dividend payment of $0.65 per share payable on April 8, 2020.

As of the end of the quarter, cash and cash equivalents were $1.7 billion and we have access to an additional $1.5 billion through our revolver. Gross debt was $4.1 billion with net debt of $2.4 billion, both fairly flat with the prior quarter. Adjusted EBITDA increased 23% sequentially to approximately $500 million, and we expect our gross debt leverage ratio to be at or below 2 times within the next few quarters.

Looking ahead to our outlook for the March quarter. As the coronavirus outbreak continues, we have made our first priority the health and well-being of our employees and partners. We are also working with our suppliers to meet customer demand and mitigate risk to production, while we currently do not expect any material financial impact in the March quarter, there is still a lot of uncertainty, and therefore, we are widening our revenue and EPS guidance ranges.

With this in mind, we expect revenue to be in the range of $2.7 billion, plus or minus 7%. At the midpoint of our revenue guidance, we expect non-GAAP operating margin to be at the high end of our long-term target range of 13% to 16% of revenue and non-GAAP EPS is expected to be $1.35, plus or minus 7%.

In general, we are seeing a change in typical seasonality as HDD demand shift away from consumer-oriented legacy market and toward mass capacity storage, driven by data growth in the cloud and at the edge.

The demand environment has continued to steadily improve particularly for high-capacity nearline drive. With a positive customer momentum we have established for our 16-terabyte products, we continue to expect both revenue and profitability to grow in fiscal 2020 with the second half revenue slightly higher than the first half of this fiscal year.

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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 performance demonstrates our ability to deliver solid financial results and drive cash generation throughout industry cycles. We are continuing to identify ways to drive further operational efficiencies to optimize profitability. We are also leveraging our strong technology roadmap, broad product portfolio, deep customer relationships, and systems architecture expertise to address secular demand for mass capacity storage and emerging opportunities to provide cost-effective data management solutions. I'm confident that Seagate is well positioned to fully capitalize on these growth opportunities while enhancing value for our customers and shareholders.

Before opening the call for questions, I would like to take a moment to thank our customers, suppliers, business partners and employees for their contributions to the ongoing success of our business.

Josh, we'll hand it back to you to lead through the Q&A.

QUESTION AND ANSWER SECTION

Operator: Certainly. [Operator Instructions] Your first question comes from Sidney Ho with Deutsche Bank. Please go ahead. Your line is open.

Q

Hi. This is [ph] Jeff on for Sidney. Gross margins were good in the quarter. Can you talk a little bit about any pricing pressure that you are seeing related to high-capacity drives?

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

A

I think I would say that the market for – on a dollars-per-terabyte basis as I look back over the last couple of years – hi, [ph] Jeff, by the way – I would say that I – you can – it's reflecting a pretty competitive space and I expect that, over the long haul, we're all going to have to make investments to answer the call in that growth space. So I think, at some point, we have to continue to work our costs down, which we're doing. We have to work through product transitions which we're doing, but we'll also have to install capital. And I expect, at some point, we're going to have to focus more on – rather than chasing share, we're going to have to focus more on making those investments.

Q

Great. And then just as a follow-up, you mentioned an increased demand for midline capacity drives as enterprises and OEMs build out their own storage needs. Can you talk a little more about this opportunity and does this potentially lead to less reliance on the cloud service providers in the future?

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

A

No. I would say, if I go back a year-and-a-half to the peak of the last cycle, thereabouts, the market was very strong across the portfolio. I think the highest capacity points typically go to the bigger customers, but I think there are many small customers globally which are still not as fully represented as they were in the peak of the last cycle, frankly, that are taking all kinds of different capacity points. And so, therefore, it's important to have a broad product portfolio and address them with the right products.

Q

Great. Thank you very much.

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

A

Yeah.

Operator: Your next question comes from Katy Huberty with Morgan Stanley. Please go ahead. Your line is open.

Katy L. Huberty
Managing Director-Research, Morgan Stanley

Q

Thank you. Good afternoon. Can you just talk about how you see 16 terabyte ramping? In which quarter do you expect the biggest sequential ramp in volume? And then, is there any reason that as 16-terabyte volumes ramp that gross margins wouldn't improve in a fairly linear fashion?

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

A

I think we can both take it, Katy. I'll pass it over to Gianluca for the gross margin part. We've said that this is one of the biggest ramps we've ever done, if not the biggest ramp we've ever done at heads and media, and we're in the middle of it and to the point of just saying this quarter we would do 1 million, and then having done 1 million, that's indicative of the strength of that ramp. The ramp is not over. It's going to keep going. And the way we look at it is there's many products in our portfolio before, but this platform is the one that's going to take us from 16 to 18 to 20 terabytes and beyond. Our ability to leverage cost and the other technology pieces that we have to put in there is great. Now that we don't have to keep transitioning products, we get a lot of leverage from that. We talked about that in the prepared remarks.

So, from my perspective, we have that strong portfolio to take us forward. I think Gianluca can speak about gross margins in particular.

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

A

Yeah, yeah. I would say, in fiscal Q2, the improvement in gross margin is coming partially from the 16 terabyte that, as we said, actually tripled the volume during the quarter, but also from an overall cost reduction on several other drives. So, looking at Q3, we will have for sure an higher volume in 16 terabyte that will help our gross margin, but, of course, depend from the overall mix of the entire volume that we move into the quarter.

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Katy L. Huberty
Managing Director-Research, Morgan Stanley

Q

Thank you. And if I can just follow up, Dave, going back to your comments about the difficulty of ramping heads and media that you executed on for 16 terabyte. If you take the demand side, there have been some questions around whether the qualifications are coming in. Can you just talk about kind of US versus China and any general numbers around how many of your big customers have qualified and are actually purchasing that product at this point?

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

A

We're fairly happy with the breadth of the qualification. I mean, if you get down to the very specific customers, they may be ready to take 16 terabyte, some of them may be back on 8s, for example. Globally, there's people that, for various reasons, they aren't ready to move there in the architecture, and we get that. In general, we're on plan with our ramp and I think our ramp's going to continue from here. The qualifications are going quite well, so I'm not worried about it at all.

I think that, as I look across the customer base, Katy, what we've talked about in the past was everybody adopting the highest capacity point quickly. I think that's happening less and less, frankly, because I think there's a lot – as we've talked in the past, there's a lot of diverse needs even within one customer set, even with one customer and then each customer may have their own different specific needs.

So I think, as the cloud grows bigger, certainly some of the scale people have diverse needs that they have to make sure that we continue to service. It's not just about the build-out of the new stuff. And it's a growing world, so we have to work with all those customers to get them exactly what they need, the 16 terabyte is doing quite well against that.

Katy L. Huberty
Managing Director-Research, Morgan Stanley

Q

Great. Thank you for the color.

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

A

Thanks.

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

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Hi. Good afternoon, guys. Thanks for taking the question. A couple from me, if I could. Just sticking on gross margin, I may have missed it, but did you make remarks about what we should expect for gross margin in the March quarter? And then, just as a follow-up to that, philosophically, as you continue to improve the yields on 16s, and then, Dave, to your point about the platform transition to 18s, same platform, why wouldn't the gross margin level up nicely once you get the 16 terabyte yields to normalize and then, as you transition on to 18s from there, once you have the cost, so the cost situation, yield situation handled?

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

Right. I think if the portfolio – if the market continues to grow, so the supply and demand is probably the first driver of all those discussions. So, if the supply-and-demand picture continues to grow in the favor of more demand and not as much supply, I think we can start asking those questions. So, that gets into cloud cyclicality. Ananda, I'll let Gianluca specifically say about how he thinks about gross margins.

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

Yeah. Hi, Ananda. You know we don't really guide gross margin. But if you look at our revenue and our EPS are fairly well aligned quarter-over-quarter. So, I'll let you take your assumption, but, no, I would not see a major change sequentially.

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

I think if we see a big demand then – and the 16 terabyte, the 18 terabyte, once we get there, is in high demand, I think we should be able to manage it. I think we talked about that a little bit last quarter as well. And what you describe may happen, but I think the broader portfolio, from our perspective, and we've said this before, we're really managing for things closer to the bottom line, like operating income. And now that we're at the top end of our range again, we're quite happy with that.

Ananda Baruah
Analyst, Loop Capital Markets LLC
Q

Great. And, Dave, you mentioned positive trajectory for hyperscale from here. Do you expect June to be up from March as well? I mean, I know things can change, but just in your base case from an...

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

I think...

Ananda Baruah
Analyst, Loop Capital Markets LLC
Q

...exabyte perspective?

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

Yeah, we've talked to the end of the fiscal year that I don't see any reason for the cycle to slow down by the end of the fiscal year. Out in the back end of the calendar year, we're not really ready to talk about that yet given all the disruptions that are going on in the market. But I will say this, I'm very happy with our product portfolio going into this next cycle whenever it comes.

Ananda Baruah
Analyst, Loop Capital Markets LLC
Q

Okay. Great. Thanks so much, guys.

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Operator: Your next question comes from Aaron Rakers with Wells Fargo. Please go ahead. Your line is open.

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

Yeah. Thanks for taking the question. I'll try and get two in here as well. Just on that final comment on the product cycle setup, I know that you mentioned during a call that you'd have 18TBs shipping in the first half of the year. Just the – sorry about the nuance here, but when you say that, do you mean that you expect to see shipments in volume in the first half of the calendar year or is that just shipments in the qualification? I'm just trying to understand the timing of those relative to your competitor.

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

A

Well, yeah, I don't really want to get into that too much, Aaron, but I would say that, in my opinion, qualification is volume. I mean, it's not one. The qualification test beds, if you will, are fairly big volume. And so it's not 1 million per quarter, like we just talked about, a few quarters into the ramp of the 16s, but, yeah, that kind of goes hand in glove.

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

Okay. Fair enough. And then, as we think about the trajectory of the business, I'm just curious now that you're breaking it out a little bit differently between mass capacity versus legacy, as we model going forward, we talk a lot about nearline, but I'm curious of how you think about the rate of decline in the legacy business as we move out over the next couple quarters or, if you want to take a stab, longer term.

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

A

Very interesting. If I think about some of the legacy businesses, the way we're thinking about them is we're not really investing much OpEx into them anymore. But we have a very broad customer portfolio that actually needs those products to go make whatever pivot they're going to make from the old world client-server IT 2.0 to the new world 4.0, right? So we have to continue to support those customers and foster those relationships with what they need. In some cases, we see surprise downsides, in other cases, we see surprise upsides based on how they're driving their markets, and we react to them.

I would say, across most of the legacy space, there's a mix-up going on. So, even if the units are coming down, the mix is going up. The use cases are still relevant, in the cases of some, there are already – as you know, there are hundreds of millions of slots for these form factors out in the world, and just to support business for that is a long tail. And that's the way I think about it is, probably, as it mixes up, it becomes more stable relatively. So it's not going away very soon. But we're not investing in it either. We're just continuing to service it predictively.

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

A

Yeah, I think Dave is raising a very good point. If you look at the importance of the legacy business in term of free cash flow, considering that the OpEx and the CapEx is fairly low in that area, it's still a good contributor to our free cash flow in general, so it's still very important to us.

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Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

Okay. Thank you.

Operator: Your next question comes from Steven Fox with Cross Research. Please go ahead. Your line is open.

Steven Fox
Analyst, Cross Research LLC

Q

Hi. Good afternoon. I hope this question wasn't answered. I got disconnected a couple of times, but in terms of looking at the competitive environment, your largest competitor has talked about maybe regaining some market share down the road this year as they launch 16TB products and above, suggesting that maybe you're over-performing on market share right now. But at the same time, you're talking about ramping more at 16-terabyte volume and 18TB is ramping. So, I guess, without throwing too many stones, I was curious what you would say about just your relative market share potential for the rest of the year.

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

A

Yeah, I would say market share is not exactly an outcome, but we need a – or sorry, it's an outcome, but it's not exactly our objective. So we made a conscious decision, if you remember, Steven, three quarters, four quarters ago, to start pivoting from some of the lower capacity points into the 16 platform. And we were very open about that just because we knew we would get to leverage into the 18s and 20s like we've talked about.

I think, as some of that happens, customers will drive us for more and more of that demand, and I think some of the puts and takes you've seen in share may change a little bit. But, again, we're trying to be predictable for those customers to get them exactly what they need. I like our plans because we happen to have the drive up the ramp already, so it's very predictable.

Steven Fox
Analyst, Cross Research LLC

Q

Okay. That's helpful. And just on a couple of follow-ups. First, on what you just said about pivoting away from lower capacity points, I guess, I was under the impression that a lot of that was in the rearview mirror, but you're saying you still may do more of that as we look out over the next 12 to 18 months. And then I had a quick follow-up.

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

A

No, no. Sorry. No, no, sorry. Well, there still are customers that need those products for various reasons, right, because of their architectures or what have you. But, no, what I said in particular is, if I go back nine months, we were very vocal about we're moving to 16s to these new platforms. And we've been focusing all of our operational resources in heads and media, things like that on those new platforms. Yeah.

Steven Fox
Analyst, Cross Research LLC

Q

Okay. I understand now. And then, in terms of gross margins, I understand you don't want to guide to gross margins, but you've mentioned several, without getting into detail, you mentioned several drivers that would seem

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to improve your gross margins considerably over the next few quarters, or at least a little bit. What are the drags that we should worry about outside of macro that could be pressure on the gross margins?

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

A

I'll let Gianluca answer. But you're hitting the right theme, which it comes down to supply and demand. So, for specific products or for the cloud cyclicality, as we've talked about before, if we've got supply and demand pretty well balanced, we should be able to manage exactly like you described. But go ahead, Gianluca.

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

A

Well, I would say that, no, we expect a high volume from our 16 terabyte and the mass capacity storage drives in general. We think our cost is declining fairly well. Of course, when you talk about gross margin, the other variable is pricing. And, no, we will have wait and see how the pricing will be during the quarter, and that will determine our gross margin at the end.

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

A

I think we've said before that, especially in the down cycle like we were in in early calendar 2019, that we're managing for free cash flow and operating income is the way we're focused. As the cloud comes back to a more of a peak cycle, then we can figure out exactly how we're going to balance our portfolio. But it starts with what the customers need and making sure we get them what they need to go achieve their business objectives. And we're always mindful of the demand cyclicality as well.

Steven Fox
Analyst, Cross Research LLC

Q

Understood. Thank you so much.

Operator: Your next question comes from Jim Suva, Citigroup. Please go ahead. Your line is open.

Jim Suva
Analyst, Citigroup Investment Research

Q

Thank you very much. If I understand it correctly, your 18 platform is going to be on the same platform as 16. And if so, when we think about that, I would assume that means that there's lower yield issues, lower risk and things like that, or is there additional complexities we should be aware of? And then when we think about once it's ramping and more volume, would the profitability be similar or why would it actually be higher just kind of talking kind of longer term?

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

A

Well, so, in theory, you're right. I would say, if we looked back over multiple generations in the industry, all the way back to 2 terabytes or 3 terabytes, we were changing platforms quite frequently, more heads and media, more – different technologies being brought to bear, and things like that, there's a new mechanical platform, so a lot of parts were changing. Exactly to your point, we've been talking about this with the 16. I think it's a highly leverageable platform for many years.

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There will be subtle changes, but I think that most of the parts are not changing, and that helps our ability to ramp, our ability to yield, and our ability to scale for the customers, be more flexible, actually, if we can move most of our product portfolio over there. So it does provide opportunities, but again, supply and demand is the key driver there.

So, Gianluca, did you have something to add there?

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

No. I think you made the point.

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

Okay. Does that make sense, Jim?

Jim Suva
Analyst, Citigroup Investment Research
Q

It does. And last thing, anything on tax rate we should be aware of for a kind of longer-term modeling for tax rate?

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

No. I don't expect any change in our tax rate.

Jim Suva
Analyst, Citigroup Investment Research
Q

Thank you so much for the details.

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

Thanks.

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

Thank you.

Operator: Your next question comes from Patrick Ho with Stifel. Please go ahead. Your line is open.

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

Thank you very much. Dave, maybe first off, in terms of the transition from 16 terabytes to 18 terabytes, you mentioned some of the ease of the customers. How do we look at it from a new customer or share win standpoint, given that the transition to existing customers probably is easy? But how do you look at it from a new customer win standpoint? Does the success of 16 terabytes help validate it for the new customers?

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

In some cases, because of the leverage, especially on firmware basis and things like that, the feature sets, things like that. But, no, in general, most customers are going to treat every new qualification with a discerning eye. They want to make sure that they do all the things right to integrate it into their data center. And again, it's – data centers are not one size fits all. There's many different applications. Some of the big customers have so many different applications. They have to worry about being able to plug this into legacy architectures or new architectures or things like that. And globally, there's many different BIOSes being used, chipsets being used, so on, you get it.

So, there is some leverage, for sure. People know the family now. They're already comfortable with the family. There is some leverage and then there's some element of a new customer you have to go through the same amount of work.

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

Great. And maybe as my follow-up question for Gianluca, in terms of the gross margin, you've given a lot of color on the call so far. In terms of the cost reduction impact versus the changing product mix, on a going forward basis, is it more of a mix issue where you could say that the cost reductions are already in place and it's now just the mix turning more favorable?

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

Yeah, probably, the mix is a major driver in (sic) [versus] the cost reduction at this point.

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

Great. Thank you very much.

Operator: Your next question comes from Munjal Shah with UBS. Please go ahead. Your line is open.

Munjal Shah
Analyst, UBS Securities LLC
Q

Thank you for taking my question. I had two. One on – could you comment on the surveillance demand? Is there anything going on with the large customers? Do you think that there is pull in or any thought for the trend in the quarter?

And then I have another one for Gianluca. Your comments suggest that gross margin should improve sequentially and your EPS guidance is flat sequentially, so just wondering if there is anything that's an offset in there.

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

Yeah. I think relative to surveillance, we have over the years seen some, I'll call it, seasonality around government buying cycles at the end of the calendar year. And as the market moves towards some smart city applications, especially globally, I think there are markets that we're seeing now that people are investing quite a bit for smart cities. You do see that cyclicality. The market is growing. I would argue that, from a units perspective, it's probably

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– there have been peaks that are bigger than the one we're in. From an exabyte perspective, obviously, we're in a growth period, and this one was a record exabyte. So, the way I look at it, every year gets a little bit stronger but there's still some seasonality cyclicality.

Shanye Hudson
Vice President-Investor Relations, Seagate Technology Plc
A

And then, Munjal, just to clarify on your second question, I caught the second part, you were saying guidance on the EPS side is flat. Could you repeat the first part of your question?

Munjal Shah
Analyst, UBS Securities LLC
Q

Right. And then the comments suggest that, I mean – comments generally suggest that gross margin should improve because your 16-terabyte mix would probably be higher in March. So, is there an offset below the gross margin line?

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

Yeah. No, as I said before, we have an assumption on pricing, of course, and all can be different when we go through the quarter, but with a fairly flat revenue, we expect a fairly flat EPS quarter-over-quarter.

Munjal Shah
Analyst, UBS Securities LLC
Q

Okay. Thank you.

Operator: Your next question comes from Nehal Chokshi with Maxim Group. Please go ahead. Your line is open.

Nehal Sushil Chokshi
Analyst, Maxim Group LLC
Q

Yeah, thank you. Recognizing that still in a growth mode on the hyperscale demand on nearline growth, that being said, the exabytes currently relative to the last peak is up only 10% versus prior peaks. Peak-to-peak is around 2x. And with the potential that you're going to be hitting a digestion phase going into calendar 2H 2020, I was wondering if you had some thoughts on why not as much potential peak-to-peak growth as in prior peaks. Any thoughts there?

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

Yeah, it's quite interesting. I didn't say that we were in a digestion phase then. But I think we've seen that cyclicality before. It's dangerous to say that'll happen exactly again because there's been a different reason for the cyclicality every time it hits. That said, I do think that the demand is growing. I think that the customers are broadening, and I also think that their ability to use higher and higher capacity points is actually getting bigger. So, once upon a time, people couldn't use more than 4 terabytes and, well, most of the market was on 8s and you're starting to see people shifting over to bigger capacity points as well. So I do think exabyte growth is still going to continue. I don't think I'm calling the top of the peak at 10% yet, so.

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Nehal Sushil Chokshi
Analyst, Maxim Group LLC

Q

Okay. Thank you.

Operator: Your last question comes from Karl Ackerman with Cowen. Please go ahead. Your line is open.

Karl Ackerman
Analyst, Cowen and Company, LLC

Q

Hey. Thanks for letting me ask a question. I wanted to maybe shift gears a little bit and talk about something that hasn't been asked yet. But just on the systems business, that was up 14% sequentially, pretty good performance. I'm guessing that segment also performed well from systems revenue, selling your high-capacity offerings, but maybe you could just discuss some of the traction you are seeing in SSDs and kind of what you're seeing for that broad segment and how we should think about that in the March quarter.

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

A

Yeah, I would say, from a systems perspective, we're happy with what we've done with the portfolio, which is we're not making boxes that don't have any Seagate products in them anymore. Now we're making boxes full of – chock-full of Seagate products, right, with lots of drives, hundred drives or plus in some of the boxes. And that's a great vehicle to go move high-capacity drives into the market quickly. So I'm happy with the pivot the team has made. I think there's opportunity to go grow it as well.

On the SSD side, I think customers are very happy with our products. We continue to service those customers, and I think I'm not the first one to be saying this, the market seems to be stabilizing vis-à-vis what it was a year ago. So we'll continue to service those customers in a meaningful way, I think.

Karl Ackerman
Analyst, Cowen and Company, LLC

Q

Appreciate that. Just maybe one last one, if I may. CapEx did spike up a little bit this quarter. When we think about the forward trajectory, are you adding capacity for 16 and 18 terabyte that speaks to what's to come in the back half of the calendar year or are you suggesting a breadth of SKUs is needed as enterprise customers' capacity needs are bifurcating between high and mid-range SKUs? Thanks.

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

A

Actually interesting. I think the first one. And it's not just that. It's also the transition that we have to make to HAMR. We think that the long lead time capital is the important stuff, the heads and media to get it online for the growth that we see in the cloud. And we're investing for it. So we're confident in our 16, 18, 20 terabyte ramps, the same platform like we've been talking about. We need to make the head/media investments to make sure that we have enough for the market when the demand is out there.

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

A

Yeah, let me add to that. We are still focusing on keeping the CapEx in the range that we gave at the Analyst Day, so between 6% and 8% of our revenue. We don't expect to go above this range in any quarter.

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Karl Ackerman
Analyst, Cowen and Company, LLC

Q

Thank you very much.

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

A

Thanks, Karl.

Operator: There are no further questions. I'll turn the call back to management for closing remarks.

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

Okay. Thanks, Josh. To summarize, we're continuing to manage the business well, optimizing profitability and generating cash to fund our future growth and deliver value to our customers and our shareholders. And the world's just creating data at a breakneck pace, which in turn drives secular growth for mass capacity storage and needs for cost-effective data management solutions. And I believe in our technology roadmap, our product portfolio. I think we're – Seagate is very well positioned to capitalize on all these trends.

So I'd like to once again thank all our customers, suppliers, business partners, employees for their contributions to our performance and also like to thank the shareholders for their ongoing support. Thank you.

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

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