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SkyWater Technology, Inc.

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Earnings Call

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Call Participants

EXECUTIVES

Claire McAdams

Steve Manko
Chief Financial Officer

Thomas J. Sonderman
CEO & Director

ANALYSTS

Ezra Weener

Harsh V. Kumar
Piper Sandler & Co., Research Division

Richard Cutts Shannon
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Shadi Mitwalli

Unknown Analyst

Presentation

Operator

Good afternoon. My name is [Audra], and I will be your conference operator today. At this time, I would like to welcome everyone to the SkyWater Technology Q2 2024 Financial Results Conference Call. Today's conference is being recorded. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. (Operator Instructions.) At this time, I would like to turn the conference over to Claire McAdams, Investor Relations. Please go ahead.

Claire McAdams

Good afternoon, and welcome to SkyWater's Second Quarter 2024 Conference Call. With me on the call today from SkyWater are Thomas Sonderman, Chief Executive Officer and Steve Manko, Chief Financial Officer. I'd like to remind you that our call is being webcast live on SkyWater's Investor Relations website at ir.skywatertechnology.com. The webcast will be available for replay shortly after the call concludes. On our IR website, we have posted a slide presentation to accompany today's call as well as the financial supplement summarizing our quarterly and annual financial results for the last three years, including all non-GAAP adjustments and comparisons to our GAAP results as well as the impact of tool sales on our gross margins.

During the call, any statements made about future financial results and business are forward-looking statements. These forward-looking statements are subject to risks and uncertainties that could cause our actual results to differ materially. For a discussion of these risks and uncertainties, please refer to our filings with the Securities and Exchange Commission, including our earnings release filed on Form 8-K today and our Fiscal 2023 Form 10-K.

All forward-looking statements are made as of today, and we assume no obligation to update any such statements. During this call, we will discuss non-GAAP financial measures. You can find a reconciliation of these non-GAAP financial measures to GAAP financial measures in our earnings release, our financial supplement and in our Q2 earnings presentation, all three of which are posted on our Investor Relations website.

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

Thomas J. Sonderman
CEO & Director

Thank you, Claire, and good afternoon to everyone on the call. I'm pleased to report strong financial results for SkyWater's second quarter with a record $93 million in revenue and our achievement of non-GAAP positive EPS for the first time. ATS development revenue of nearly $62 million exceeded our expectations to reach a new record up 1% from Q1 and up 18% compared to Q2 of last year. This growth was driven primarily by continued strength in our Aerospace and Defense business, which exceeded forecast due to pull-ins of demand on multiple programs, which we delivered through improved bad cycle times and agile just under $6 million, slightly better than expected, but still well below prior run rates due to continued weakness in the broader industrial segment.

Tool revenues exceeded our forecast at $26 million with enhanced equipment lead times, enabling faster deliveries within the quarter. Customer-funded tool installations demonstrate our customers' commitment to bring additional capabilities and capacity into our fabs to support their most critical programs. We believe we are in the early stages of an anticipated multiyear period of elevated customer co-investment. These investments are adding critical new capabilities in our fabs and will enable substantial additional scale to our business while maintaining our streamlined cost structure given minimal SkyWater funded CapEx needs.

With the record results and the revenue upside in ATS, we achieved non-GAAP EPS positive results for the first time this quarter. With strong gross margin flow-through and ongoing efficiency gains, we have now demonstrated the expected business level necessary to support profitable results in the future. We believe our CapEx-light and high operating leverage business model will lead to a significant expansion of our gross margin profile aligning strong profitable results in the years to come.

Today, I will highlight several positive developments in our business and provide our current outlook within the overall customer demand environment. First, our strong results for Q2 and continued confidence in the growth expected in our ATS business for Fiscal 2024 underscore the strategic importance of multiple aerospace and defense programs underway at SkyWater. Altogether, our expectation is that the majority of our growth this year will be driven by several strategic A&D programs witnessing consistently strong demand coupled with steady improvements in our capabilities and operational execution.

For Q2 specifically, we witnessed some pull-ins of demand from the second half, which we expect will result in a slightly front half loaded year for our ATS business in 2024. Overall, we believe these programs are secure and well-funded. The added revenue tailwind of record-level tool sales is yet another proof point of our customers' confidence in SkyWater as a trusted domestic source of critical semiconductor technology. Next, we are pleased to announce another successful customer transition from ATS to wafer services, this time for biomedical pioneer, Quantum-Si. We have remained committed to our focus on next-generation medical technologies, in particular, for the novel categories of the instruments and devices that leverage our unique service model that enables highly differentiated and customized technologies.

Our recent collaboration with Quantum-Si will support a key facet of their state-of-the-art proteome sequencing technology to enable enhanced analysis of proteins anticipated to propel a variety of life sciences applications, including drug discovery. We continue to believe that these types of customer partnerships build a strong foundation for the future growth of our commercial businesses, where in addition to advanced Biomedical, we see strong potential for our advanced compute and thermal imaging platforms.

Another exciting development is the recent installation of multi-beams high productivity, direct right patterning system into our Minnesota fab. The first of its kind multicolumn e-beam lithography, our MEBL system, enables the most advanced 200-millimeter patterning solution capable of sub-50-nanometer geometries currently available from early concept prototyping through production ramp. We consider this new direct right lithography capability, which is orders of magnitude faster and more productive than conventional e-beam solutions, as a key development towards supporting strong customer demand for our technology as a service, our TAS, business model.

MEBL accommodates high topography and curve-linear designs to enable 3D devices such as MEMS and photonics and also can enable secure chip identification for anti-counterfeit applications as one example. MEBL can also enable advanced packaging for very large and custom interposers. We are very excited to add this capability and artist feed the concept of production journey in secure defense, biomedical, thermal imaging and a high reliability and advanced compute markets.

Another highlight since last quarter is the first tool delivery of our new fan-out wafer level packaging platform in Florida. With the arrival of tools accelerating as we move through the next several quarters, we anticipate ATS development on this exciting new technology to ramp up throughout 2025. We have already begun engaging a broad set of customers across both defense and commercial applications, including Tier 1 semiconductor companies. We believe there is a clear market demand for domestic advanced packaging services that can support wafers from any foundry.

We have secured $120 million in outside funding to complete the tooling and facilitization of our Florida operation. This first new tool of delivery for our 300-millimeter capable fan-out packaging line is an exciting milestone for our emerging fans packaging business.

Now turning to our outlook. Our full year revenue expectations for ATS and wafer services in 2024 are largely unchanged since our last earnings call. We continue to expect ATS development growth in the range of 10% to 20% over 2023 and a meaningful decline in our legacy wafer services revenue. Today, we are once again increasing our forecast for customer-funded CapEx investments, which for SkyWater are recorded as tools revenue. We now expect approximately $80 million of customer-funded CapEx investments in 2024. With strong operational performance as we install and ramp up these new systems, we are executing well in our expected path to install over $200 million of new customer-funded tooling spanning 2024 through 2026.

For Q3 specifically, we are forecasting total revenues to be slightly higher than Q2. Within this forecast, APS development revenue is expected to be $60 million, plus or minus 3% and wafer services revenue in the $4 million to $5 million range. With our current visibility, we believe wafer services is likely to remain quite soft for at least another quarter or two, reflecting the continued weakness in the broader industrial market. That being said, we are optimistic for a return to growth for wafer services in 2025 driven by the thermal imaging and medical diagnostics segments. With customer-funded CapEx continuing to ramp to record levels, tool revenue in Q3 is expected to be approximately $30 million.

Finally, we are driving for incremental growth in each of our businesses as we move into 2025, and we look forward to continuing to build your confidence in our ability to execute on our growth and profitability objectives.

I will now turn the call over to Steve.

Steve Manko
Chief Financial Officer

Thank you, Tom. Second quarter revenue reached another record for us at $93.3 million with upside reported in all three revenue components. Total revenue was up 17% from Q1 and up 34% from the second quarter of 2023. The record ATS development revenue of $61.7 million exceeded our forecast for the quarter as a result of strong demand and acceleration on our strategic aerospace and defense programs. While we had expected a modestly lower ATS run rate entering Q2, actual ATS revenues increased slightly from the first quarter.

As expected, wafer services revenue declined meaningfully from our prior run rate but still came in a bit higher than forecast at $5.8 million. Tools revenue was $25.9 million compared to our outlook for at least $20 million with the accelerated delivery of tools near quarter end. Our non-GAAP gross margin for the quarter was 18.9% at the upper end of our guidance range due primarily to stronger ATS and wafer services revenue compared to our forecast. Tools revenue in the quarter impacted non-GAAP gross margin by 570 basis points. As a reminder, you can find the impact of tool revenue on our gross margin each quarter and financial supplement posted to our IR website.

Non-GAAP operating expenses were $13.5 million, which was well below the forecast primarily due to lower variable compensation and a shift in timing of certain other comps to subsequent quarters. With the upside in gross margin and lower OpEx, non-GAAP operating income was well ahead of forecast at $4.1 million. Adjusted EBITDA was $8.1 million, and we achieved a non-GAAP net income of $0.02 per share.

Turning to the balance sheet. The balance of total cash at quarter end at $18.4 million has remained relatively consistent since year-end 2023. We generally manage our cash needs through inter-quarter draws on the revolver, which also helps minimize our overall borrowing costs. Q2 was a strong quarter of free cash flow generation with $9.3 million in cash flow from operations and $1.1 million of CapEx. Positive cash flow from operations consisted of approximately $5.8 million generated from the P&L and $3.5 million benefit from working capital changes. During the quarter, we reduced our overall indebtedness by $5.6 million with $66.3 million in total debt outstanding at quarter end. We currently have $74 million available on our revolver.

Turning to our outlook for Q3 and our expectations for various financial metrics as we move through 2024 and into 2025. As Tom mentioned, with our current visibility, we expect Q3 total revenues in the mid-$90 million range. This reflects our forecast for ATF development revenue of $60 million, plus or minus 3%, $4 million to $5 million for wafer services revenue and approximately $30 million of tool sales. Given this expected revenue profile, we expect Q3 non-GAAP gross margin in the mid- to high teens. Our gross margin expectations reflect the increased mix of tool sales expected in the quarter, which we expect will impact gross margin by approximately seven percentage points or 700 basis points. We expect non-GAAP operating expenses of approximately $14 million for the third quarter and to remain in this range through the end of Fiscal 2024.

For the full year, our revenue outlook is largely unchanged this last quarter. We continue to forecast ATS development revenue growth in 2024 in the range of 10% to 20%, while the prolonged industry softness affecting our wafer services business is expected to result in a revenue decline of 60% to 65% for the full year. Today, we have increased the expected level of tools revenue for the year to approximately $80 million.

Finally, here are a few more of our assumptions for our quarterly results. Our OpEx run rate is lower than previously forecasted for 2024 as a result of good execution on our top control initiatives as well as deferment of certain spending to future quarters. As a result, the run rate is likely to be somewhat higher as we move into next year. While overall debt levels will fluctuate through the year depending on draws from our revolver, we believe $2.5 million to $2.9 million in quarterly interest expense is a good assumption for the foreseeable future as we continue to benefit from over $20 million of advanced customer deposits for tool purchases.
For the remainder of 2024 for modeling purposes, you should assume nominal to no tax expense or benefit. Our income from variable interest entities below the line is not something we can predict with accuracy, but $1 million is a historical average that we expect will be appropriate to use for your models looking forward. With that, I'll turn the call over to Q&A. Operator, please open the line for questions.

Question and Answer

Operator

We will now begin the question-and-answer session. (Operator Instructions.) And our first question goes to Harsh Kumar at Piper Sandler.

Harsh V. Kumar
Piper Sandler & Co., Research Division

Congratulations on a very, very strong execution. Tom, I had one for you. I guess the question was what kind of programs are you seeing in ATS? You talked about aerospace and defense being the dominant sort of force in the results this quarter. And you talked about discontinuing on for the rest of the year. So, I was curious if there's a specific area of aerospace in defense where people are coming to you more than other areas? Or is it pretty broad-based?

Thomas J. Sonderman
CEO & Director

Well, clearly, we talked before about thermal imaging. I think that's a strong growth area as far as there is a variety of special programs, what we referred to as specialized ASICs, that drive a lot of our engagement with the aerospace and defense business. And then, of course, we talked before about the RadHard program, which, while it gets a lot of attention today is a relatively small component of our overall A&D business. So I bucket it in those three broad categories.

Harsh V. Kumar
Piper Sandler & Co., Research Division

I got you. Okay. And then for my follow-up, Tom, you're equipping the Florida fab. It sounds like your -- I think you're getting closer to commercialization at some point in time in the near term, but could you maybe help us think about what this sort of facility for advanced packaging can do for you and what the contribution could be when it's all put together and sort of humming and running?

Thomas J. Sonderman
CEO & Director

Yes. So over the last several years, we've been, of course, facilitizing the clean room, getting the fab essentially ready to run the development programs that we currently have up here in Minnesota. The difference, of course, being the focus on advanced packaging in Florida. We've put in an interposer program that was the first program that came via IMEC. We put in a hybrid bonding capability that has been slowly ramping up. But the one that's the most exciting and the one that is really just beginning to move forward is the fan-out wafer level packaging capability that we announced back in January. That's the $120 million investment that will allow us, again, via the DoD's investment to stand up a Gen 2 version of DECA Technologies technology, our adaptive patterning based technology, and we expect the Florida operation to be sufficient for prototyping, early-stage production, but anything beyond that would obviously require an investment in a larger type facility.

So, think of it as an ATS-like capability that will begin to really add to the top line as we get into next year as we're standing up the technology. Then as you get into the out years, you would begin to see that transition away for services, but it will be primarily ATS development-related revenue in Florida as that program matures.

Operator

We'll move next to Krish Sankar at TD Cowen.

Unknown Analyst

This is [Steven] calling on behalf of Krish. Tom, maybe a first question for you in terms of your demand for Wafer Service customers. I know you just mentioned in the prepared remarks that demand will be relatively soft for the near term. So, I'm just kind of wondering in terms of your conversations with customers, especially your large European ones, what kind of, I guess, demand signals are they giving you in terms of two to three quarters out? If there's any of those conversations happening? Is the relative work down of inventory that some of your customers have been talking about? Is that more favorable for you? Or is that other areas of the business that doesn't touch upon the WS business?

Thomas J. Sonderman
CEO & Director

Yes. So clearly, when it comes to Infineon, who is our largest legacy wafer services customer, they continue to have weakness. I think they announced their earnings a day or so ago. So, the industrial segment that we primarily service continues to be weak. We think it will be weak for the rest of this year. That's what we're modeling. And then as we get into 2025, we do see, and are expecting like many, to see a modest recovery in the legacy business, but it's really going to be our focus to continue to accelerate the thermal imaging capabilities, continue to transition our ATS to Water Services customers, which, as we've been discussing, is really focused around the biomedical space and then, of course, continue to make progress on things like thermal imaging, like I mentioned, which we believe will move -- start moving into production as we move into next year.

So, we're hopeful like many that eventually, the legacy businesses will start coming back, but we are definitely pivoting towards the future, which is really taking the technologies we've been developing with our customers over the last several years and helping get those ramped into production because that's really what's going to drive the profitability side of the wafer services business just like we have today in ATS.

Unknown Analyst

Great. Well, my second question, I had one for Steve regarding the I guess, the longer-term CapEx needs for the Florida packaging facility. So, relative to that $120 million to be spent between now and 2026. Just to clarify, is that $120 million, is that part of the original $190 million of funding that we've announced with that fan-out wafer level packaging, or is this on top of that $190 million? And secondly, for the $80 million of tool revenue that you guys are expecting this year, does that include any of that CapEx related to Florida?

Steve Manko
Chief Financial Officer

Yes. Good question. So I'll start with the last question first. So part of that $80 million has a very small amount of the tool revenue going into Florida for 2024. So, that would be item number one. Item number two, going specifically to Florida than what we talked about with the $120 million going into Florida for the fan-out wafer packaging, as Tom mentioned, that would take place over a couple of years, really starting in 2025 and then flow back into 2026. That amount, like you said, though, what has been awarded is 120, there's potential upside to that program to go to something like $190 million and maybe something above that. We've seen that happen with other programs before where they -- we start getting more and more money as we are successful with various stages of the program. But just to keep everything straight what we're talking about by putting out the fan-out wafer packaging in Florida that is part of the $120 million program we announced last year.

Operator

We'll move next to Shadi Mitwalli with Needham & Company.

Shadi Mitwalli

This is Shadi Mitwalli on for Quinn Bolton. I have a question on the MEBL system, SkyWater received. Can you expand on what this means for SkyWater in the near and long term? And can you talk about the customer interest you have received with that capability?

Thomas J. Sonderman
CEO & Director

Yes. Great question. So this is obviously a new system that SkyWater is very excited to now have in our fab. E-beam traditionally has been a technology that is used for, we'll call it, more exotic type processing. It's slow. It doesn't have high productivity and again, is geared towards a certain type of application. Those type of applications actually align very well with what SkyWater does, which leverages a lot of customization and focus on optimizing co-optimization of the process and the product. So, the multi-beam capability because it's 10x to even 100x faster than traditional e-Beam allows more customers that want to take advantage of a direct right capable other collateral that you get with an optical solution, it just opens up many more opportunities for us. Again, as I mentioned in my remarks, for MEMS, curve linear designs, things that are really aligned with the type of work that we do at SkyWater.

So, the fact that it provides a new kind of conduit of customers, but also allows us to go below 50 nanometers at 200-millimeter makes it very unique and puts SkyWater in the position as the most advanced 200-millimeter fab from a geometric perspective in the world. And we believe that will drive a lot of innovation, not only within our existing customer base, but as investments start flowing through chips-related funding, we just think it's going to be a great opportunity for us to really exploit our leading-edge 200-millimeter capability.

Shadi Mitwalli

And then my follow-up is on Quantum-Si, transitioning into wafer services. How long have you guys been working with them before the transition? And can you give any color on the timing and capacity ramp?

Thomas J. Sonderman
CEO & Director

Yes. So typically, the biomedical solutions are about two years of ATS engagement, and that's true in the case of Quantum-Si. As we get to the point of freezing the process, we then go through a qualification period. We provide the initial samples and then they complete the rest of their qualifications. That can take upwards of a year depending upon the level of approvals that are needed. So, we would start seeing ramps of many of these biomedical programs as we get into the later part of next year going into 2026, I would anticipate. Of course, along the way, there will be more samples that will be needed, but this is what we talked about the J-curve effect as you come out of ATS development, there is definitely going to be a lull before the wafer services revenue kind of picks up from where we left off in the ATS revenue. And think of that as about a 9 to 18-month time frame. Again, we're kind of just moving through the process. So, we're getting data on this as you guys are getting data on it, but that's the way I would generally think of it.

Operator

We'll move next to Richard Shannon at Craig-Hallum.

Richard Cutts Shannon
Craig-Hallum Capital Group LLC, Research Division

I may follow up on the last one here and maybe ask the question more broadly about all of your ATS customers that have or at least you talked about transitioning or transition to ATS here. Tom, I wonder if you could kind of paint us the picture about when do we see revenue profile from these new customers that becomes noticeable, maybe even becomes bigger than the kind of the legacy wafer services revenue stream to have right now.

Thomas J. Sonderman
CEO & Director

Yes. Great question, Richard. I think it's kind of, again, like we talked in our remarks, we believe we're going to start seeing growth again in wafer services next year. Some of that growth will come from these ATS wafer services transitions. We clearly are being conservative in terms of how we think these programs will ramp because they're very much out of our control. Once we get the solutions provided to our customers, they have to build the rest of the systems and get the quals done. So, whether it's in the biomedical space or in the case of Lumotive, and the ADAS space, we believe it's going to be a series of quarters. But as you get into the -- again, the later part of 2025, moving into 2026, I think you'll start seeing an acceleration in the pace of their ramp -- and then the other thing you can expect is that we'll continue to have customers transitioning. So, much like in the early days of ATS where we didn't have a broad portfolio of customers, when one would slow down it tended to be more noticeable, we expect as you get in the out years and we get multiple programs in wafer services, they'll all be ramping at different paces. But overall, you're going to see growth in wafer services that is no longer dependent on our legacy business, and that's really the exciting opportunity that we think we have before us because the slowdown has allowed us to accelerate the focus on ATS, which is driving these programs faster and faster through the conversion, and that just gets them out in the market quicker so that we can capture the upside when it materializes.

Richard Cutts Shannon
Craig-Hallum Capital Group LLC, Research Division

Okay. And my follow-up, this is probably mostly for Steve. Steve, obviously, you hit a nice level of profitability here in the quarter, which is obviously great to see, and you didn't have enough time to really run your forward numbers through my model in any great detail here. But it sounds like we could see close to profitable, if not profitable quarters for the next couple few or so. Maybe I just want to comment generally on what you see profitability versus play losses in the near future here, kind of big picture.

Steve Manko
Chief Financial Officer

Yes. Good question. I mean, that's something that we've been waiting for, for quite some time. We were clearly excited to announce that we hit non-GAAP EPS positive for the quarter for the first time. I think what this shows is the second level of financial modeling. We talked about the leverage of our model from a profitability perspective. In the second quarter of 2022, I believe we talked about generating 50% or greater flow through on gross profit once we exceeded $45 million of the fixed cost. Now as we demonstrated for the past couple of quarters, you're seeing a new revenue profile. And remember, the real margin right now is coming from ATS and wafer services, something in the upper 60s to 70% for ATS and wafer services revenue coming through, that's really looking like our next breakeven on the profitability standpoint. So, there could be some puts and takes each quarter depending on exactly what that revenue profile looks like and maybe even more importantly, what the cost side of the house looks like. But I think we're demonstrating pretty consistently that in the upper 60s, we can really get very close to non-GAAP EPS and non-GAAP profitability. I think that's something that we can look forward to going forward at those revenue levels.

Operator

(Operator Instructions.) We'll go next to Ezra Weener at Jefferies.

Ezra Weener

A quick question. You guys talked about Quantum-Si and moving that from ATS into wafer services. Obviously, that's a great step trying to -- as you try to do that with more of the ATS business. Can you just talk about that pipeline going forward?

Thomas J. Sonderman
CEO & Director

We have, I think, announced now four different customers that have done a conversion this year. There's more slated as we get into the later part of this year, another one or two. And then as we get into next year, again, we're not going to get into this many per year kind of cadence, but we have others that we expect to begin to transition. And as I was just alluding to, over time, what you'll see is just more and more of those customers converting they'll each be ramping at their own rates, but the ability to replace the legacy volume with new, highly profitable technologies that we help create with our customers that are just beginning to enter the market, we think, is a huge opportunity for us.

And what you're seeing is profitability at the very lowest levels of wafer services revenue as those wafer services revenue begin to move back up and to the right, we're absorbing the fixed cost of the business, as Steve was just alluding to. We're seeing now where the true breakout point is, and we believe we're very well positioned to capture that upside with a very efficient business model we put in place.

Steve Manko
Chief Financial Officer

And again, I think you're seeing a new phase of our business that we've been talking about for quite some time, materializing before where it's maybe only one or two per quarter that we're talking about. We're not guaranteed with timing to have one every quarter, but there's been a consistency that you've seen this year with more and more customers routinely moving from ATS to wafer services. And that's an exciting time for our business that we've been waiting for. With that, we expect more and more customers to do so, then we'll have better information on really what the pipeline looks like and when we can expect revenue from those new wafer services customers.

Thomas J. Sonderman
CEO & Director

And I'll just add, we're always adding to our ATS pipeline as well, whether it's advanced compute, more biomedical, things in the AI IoT space. We have lots of exciting customers that are just coming on board and others that continue to move through the pipeline. And that is the real story of SkyWater as we took a legacy fab through our ATS model. We brought in a lot of new exciting customers and opportunities. And as those move into volume production we'll essentially have replaced legacy buying with new SkyWater created technology that literally is just beginning to enter the market.

Ezra Weener

Awesome, thank you very much.

Steve Manko
Chief Financial Officer

That's a very CapEx-light model. Sorry.

Operator

And that concludes our Q&A session. I will now turn the conference back over to Thomas Sonderman for closing remarks.

Thomas J. Sonderman
CEO & Director

Thank you, operator. I'm going to close today's call by conveying the strong confidence all of us at SkyWater have and our ability to execute successfully towards our long-term growth opportunities and profitability objectives. It is our intent to continue to build your confidence in our capability to execute. We anticipate that additional opportunities to meet with investors during the third quarter will include the Virtual Needham Semiconductor Conference and the Jefferies Semiconductor Summit in Chicago later this month as well as the Piper Sandler Growth Frontiers conference in early September. And please feel free to reach out to Claire directly to follow up with us. We look forward to talking with you again on our Q3 call in November. And with that, I'll conclude today's earnings call.

Operator
Thank you. And this concludes today's conference call. Thank you for your participation. You may now disconnect.