S&P Global
Market Intelligence

SkyWater Technology, Inc.

NasdaqCM:SKYT

Earnings Call

Thursday, November 7, 2024 9:30 PM GMT

Call Participants

EXECUTIVES

Steve Manko
Chief Financial Officer

Thomas J. Sonderman
CEO & Director

ANALYSTS

Krish Sankar
TD Cowen, Research Division

Nicolas Emilio Doyle
Needham & Company, LLC, Research Division

Richard Shannon

Robert Aguanno

ATTENDEES

Claire E. McAdams
Headgate Partners LLC

Presentation

Operator

Ladies and gentlemen, thank you for standing by. My name is Krista, and I will be your conference operator today. At this time, I would like to welcome everyone to SkyWater Technology Third Quarter 2024 Financial Results Conference Call.Â [Operator Instructions]

I would now like to turn the conference over to Claire McAdams, Investor Relations for SkyWater. Claire, you may begin.

Claire E. McAdams
Headgate Partners LLC

Thank you, operator. Good afternoon, and welcome to SkyWater's Third 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 a financial supplement summarizing our quarterly and annual financial results for the last 3 years, including all non-GAAP adjustments and comparisons to our GAAP results as well as the impact of tool sales on our gross margins.Â

During the call, any statements made about our 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 Q3 earnings presentation, all 3 of which are posted on our Investor Relations website.Â

Also on our Investor Relations website Events page, you will see that we plan to participate in 2 investor events between now and our next earnings call, the New York Summit on December 17 and the Needham Growth Conference on January 15.

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 announce another record quarter for SkyWater with $94 million in revenue, driven by unprecedented levels of customer co-investment and $0.08 positive non-GAAP EPS. Combined ATS and Wafer Services revenue totaled $63 million. Tools revenue, which represents customer-funded CapEx investments increased to an all-time record $31 million, driving our ninth consecutive quarter of sequential growth and record revenue.

ATS development revenue of $56 million demonstrated year-over-year growth of 5%, but declined 9% from our record Q2. ATS activity was a bit softer than we expected, largely due to funding constraints at some of our A&D customers as we near the end of the government's fiscal year.Â Our ability to quickly balance ATS activity requirements with Wafer Services demand allowed us to move more production wafers through the fab, which resulted in Wafer Services revenue exceeding our expectations at nearly $7 million.

We delivered 22% gross margin for the quarter, well above expectations. This was driven by our continued focus on operational efficiencies and improved execution on a significant A&D program, which enabled us to deliver key milestones with lower-than-expected costs and recover the majority of the $8 million cost accrual recorded in Q1. Steve will provide greater detail on our strong gross margin performance during his remarks. In all, Q3 was an important quarter of execution on key programs, resulting in significant gross margin and earnings upside in spite of the temporary softening in ATS revenue.

Now I will highlight several positive developments in our business and provide our current outlook within the overall customer demand environment. First, consistent with our expectations throughout the year, we expect to deliver double-digit revenue growth in our ATS business this year. We expect to return to sequential growth in ATS revenue in the fourth quarter after the temporary decline in Q3, which we expect will result in a record ATS year for us in 2024. This anticipated robust growth year for ATS underscores the strategic importance of multiple aerospace and defense programs underway at SkyWaterÂ as well as several emerging growth technologies being developed for our commercial customers.Â

At the midpoint of Q4 expectations, our 3-year CAGR for ATS revenue exceeds 35%. At the same time, we are demonstrating steady improvements in our operational execution, which is an important outcome from the business transformation process we undertook last year. We believe the added revenue tailwind of record level CapEx co-investment is yet another proof point of our customers' confidence in SkyWater as a trusted domestic source of critical semiconductor technology.

Next, we're pleased to announce a multiyear supply agreement with NanoDx, a pioneer of in vitro diagnostics and biosensor applications. They are currently completing the development of a revolutionary biosensor that is the foundation of the rapid point-of-care diagnostic platform.Â

NanoDx is initially focused on traumatic brain injury applications with a clear path to various other disease states, including stroke and infectious disease. This agreement marks an important step forward, reflecting our progress and readiness to support NanoDx on their path towards commercialization. We continue to believe that these types of customer partnerships build a strong foundation for the future growth of our commercial Wafer Services business, where in addition to advanced biomedical, we see strong potential for our advanced compute and thermal imaging platforms.Â

Next, expanding our leadership in critical semiconductor technologies is our growing role within the Microelectronics Commons Initiative, an important element of the CHIPS Act. Established under the National Defense Authorization Act, the Microelectronics or ME Commons initiative is designed to accelerate U.S. innovation in microelectronics and strengthen national security.

SkyWater has been selected as a key performer for multiple ME Commons projects spearheaded by the Southwest Advanced Packaging Hub and the Northwest AI Hardware Hub. These projects in the initial round of funded programs aim to advance scalable low-power microtechnology solutions that support AI hardware development and other high-impact national security applications.Â

Another highlight since last quarter is the appointment of Bassel Haddad as Senior Vice President and General Manager of Advanced Packaging. Bassel is charged with building and scaling SkyWater's advanced packaging business serving both the defense and commercial market sectors. His commercial sector experience will be pivotal in cultivating key new customers and partnerships to build a strong, scalable manufacturing presence in the United States. His proven track record at Intel, where he effectively managed large-scale business lines and engineering projects highlights his ability to rapidly translate strategies into operational success.Â

During the quarter, we continued to place new tooling purchase orders funded by the $120 million award announced earlier this year. As Moore's Law is slowing down, 2.5D and 3D advanced packaging becomes the next frontier of semiconductor technology innovation, the unprecedented demand for computation in the AI era makes heterogeneous integration a pivotal capability fueling the next phase of semiconductor growth. We believe SkyWater is uniquely positioned to be a leading domestic supplier of advanced packaging solutions, serving both defense and commercial customers.Â

Now turning to our outlook for the fourth quarter. With our current visibility, we expect total revenue of $72 million to $76 million, of which approximately $11 million is expected to be tools revenue. Therefore, we expect combined ATS and Wafer Services revenue to be $63 million, plus or minus $2 million. Within this range, we expect sequential growth for ATS with revenue in the range of $58 million to $61 million and Wafer Services revenue in the range of $3 million to $4 million.Â

Looking ahead to 2025, we are encouraged by a robust pipeline of secure A&D demand, growing momentum across multiple commercial programs and the initial ramp of our advanced packaging business. Growth in our ATS segment is expected to be driven by strong continued momentum across various A&D programs and new well-funded commercial initiatives.Â We expect these advancements to be bolstered by substantial new tooling capabilities funded by our customers, during this unprecedented period of co-investment.

Additionally, we plan to accelerate our advanced packaging ATS development as we ramp our new fan-out platform. We expect revenue from our Florida fab in 2025 will be a mix of ATS and tools. In our Wafer Services segment, we anticipate increasing demand from commercial programs that have and will transition from ATS to production. Together, we believe these factors position us well for continued expansion of our combined ATS and Wafer Services business in 2025.

Finally, for tools. We continue to expect approximately $200 million of total customer co-investment between 2024 and 2026. Our tool delivery schedule indicates a current estimate of $40 million to $50 million for 2025 as we continue to ramp our advanced packaging business in Florida and incorporate new tooling in Minnesota. We expect that these capabilities will greatly enhance the solutions we can provide to our customers, driving growth long into the future. Altogether, our outlook for 2025 supports continued top line growth and gross margin expansion as we progress through the year.

I will now turn the call over to Steve.

Steve Manko
Chief Financial Officer

Thank you, Tom. Third quarter revenue reached another record for us at $93.8 million. Within this new record, ATS revenue was lower than forecast at $56.4 million, given the government fiscal year budget constraints Tom discussed earlier, while Wafer Services was higher than forecast at $6.7 million. Combined ATS and Wafer Services revenue was $63.1 million in the quarter and tools revenue reached an all-time record at $30.7 million. As a reminder, the additional metrics discussed today are non-GAAP measures.

Our gross margin performance for the quarter exceeded our expectations entering into the quarter. On our August call, we guided Q3 gross margin in the mid to high teens or approximately 17% at the midpoint. We also guided an expected 7 percentage points of negative gross margin impact from tools revenue for the quarter, equating to an effective 24% margin at the midpoint expected for our combined ATS and Wafer Services business in Q3.

Our reported Q3 gross margin was 22.3%. The record level of tools revenue impacted gross margin by about 10.5 percentage points, equating to an effective 32.8% gross margin for our combined ATS and Wafer Services business. The most significant driver of the gross margin upside was the reversal of the majority of the $8 million cost accrual recorded in Q1. We made strong progress delivering on key program milestones and recovered $5.6 million of the accrual during Q3. This had a 9-percentage point positive impact on gross margin for the quarter.

So with a reported gross margin of 22.3%, the 10.5 percentage point negative impact of tools and the 9-percentage point positive impact of the reversal, Q3's gross profit equated to 23.8% gross margin performance for our combined ATS and Wafer Services business. The continued strength in gross margin was driven primarily by improved operational efficiencies and continued progress in our ongoing cost reduction strategies. Operating expenses were $14.1 million, aligned with our expectations for the quarter. Given the $5.6 million accrual recovery, operating income was well ahead of forecast at $6.8 million. Adjusted EBITDA was $11 million, and we achieved non-GAAP net income of $0.08 per share.

Turning to the balance sheet. The balance of total cash at quarter end at $20.7 million has remained relatively consistent since year-end 2023. We generally manage our cash needs through intra-quarter draws on our revolver, which also helps in minimizing our overall borrowing costs. Our interest expense was lower than forecast in Q3 as a result of our ability to minimize our revolver balance for much of the quarter.

We were free cash flow positive once again in Q3 with $14.3 million of cash flow from operations. Positive cash flow from operations consisted of approximately $9 million generated from the P&L and a $5 million benefit from working capital changes. During the quarter, we reduced our overall indebtedness by approximately $6 million with $60.8 million in total debt outstanding at quarter end. We currently have $76 million available on our revolver.

Turning to our outlook for Q4 and our expectations for various financial metrics as we move through 2024 and into 2025. As Tom mentioned, with our current visibility, we expect Q4 total revenue of $72 to $76 million. This reflects our expectations of $58 million to $61 million of ATS revenue, $3 to $4 million of Wafer Services revenue and $11 million of tools revenue. Our Q4 revenue guidance demonstrates solid execution toward our growth objectives entering 2024.

Despite budget constraints affecting ATS in Q3, we continue to expect a solid growth year within the 10% to 20% range. And with our current visibility today, our expectations are in the range of 12% to 14% growth over 2023. We expect Wafer Services revenue this year will end up slightly favorable to the 60% to 65% year-on-year decline forecasted a quarter ago. We currently expect 2024 tools revenue of approximately $76 million. In total, expectations for revenue growth in 2024 are in the range of 18% to 20%.

Turning to Q4 gross margin guidance. At the midpoint, we expect similar gross margin performance on a similar quarter of combined ATS and Wafer Services business levels. With Q4 gross margin expected to be in the range of 19% to 23% and an anticipated tool impact of 300 basis points, at the midpoint, our Q4 guidance represents 24% gross margin performance for the combined ATS and Wafer Services business.

We expect operating expenses in the range of $14.5 to $15 million interest expense in the range of $2.5 to $2.9 million and nominal tax expense for the fourth quarter. Assuming that income from non-controlling interest remains approximately $1 million, the resulting non-GAAP EPS range for Q4 is a loss of $0.04 to a loss of $0.10 per share.

Finally, here are a few more of our assumptions for our quarterly results as we move into 2025. Tools revenue is currently expected to be in the range of $40 million to $50 million in 2025. And with our current visibility, we expect the majority of Tools revenue to be recognized in the second half of the year. Our OpEx run rate has been running at the lower end of expectations as a result of good execution on our cost 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 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 2025, for modelling 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 historic 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

[Operator Instructions] Your first question comes from the line of Krish Sankar with TD Cowen.

Krish Sankar
TD Cowen, Research Division

I had 2 of them. First one, Steve, I just want to make sure that I got your guidance right. On the gross margin side, you said is 19% to 23%. Is it mainly because backing out the tool revenue, the revenue is effectively flattish sequentially ex tools?

Steve Manko
Chief Financial Officer

Yes, that's right. Probably a flat quarter-to-quarter on the ATS and Wafer Services revenue, and therefore, a very similar margin for ATS and Wafer Services business in Q4. So, 19% to 23% was the range provided.

Krish Sankar
TD Cowen, Research Division

Got it. And then I had a question on -- just on 2025. A two-part question. One is, how should we think about the March quarter? Are we going to see seasonality for ATS and Wafer Services? So revenue should be down and therefore, gross margin should be down? And what to think about ATS and Wafer Services for calendar '25 as a whole? Would you expect it to grow? Or is it still dependent on semi market recovery?

Thomas J. Sonderman
CEO & Director

Yeah, so the way we're looking at Wafer Services is we see overall growth next year in '25, again, with a higher concentration of our ATS to Wafer Services conversions being the primary driver. And then, of course, ATS, we still expect to see growth in ATS next year. The real seasonality we typically see is in Q3 as we end the fiscal year given the current concentration in A&D. But overall, we expect to see combined core growth or ATS plus Wafer Services going up next year. And Steve, do you want to answer?

Operator

Your next question comes from the line of Quinn Bolton with Needham.

Nicolas Emilio Doyle
Needham & Company, LLC, Research Division

Nick Doyle on for Quinn. The tool revenue guide for 4Q is, I think, coming in a little softer than expected and then '25, I think, coming in a little softer as well. So it seems like a little bit of a pause here in the next couple of quarters. Anything specific you can talk to on that line?

Thomas J. Sonderman
CEO & Director

Yes. I mean, typically, we project when we think tools are going to arrive, the timing of some of those tools, again, is highly dependent on our tool supplier. So that's part of what you're seeing. And then again, as we get into 2025, we're projecting based on current delivery schedules, what we anticipate coming into our fabs. What we're confirming is the $200 million over the '24 to '26 period and the specific cadence will be highly dependent on when our customers engage with us to place the orders and then, of course, when we actually get the tools delivered.

Steve Manko

Chief Financial Officer

Yes. With what we're seeing for the fourth quarter, we said up to $80 million for 2024. With what we just guided for the fourth quarter, we would just be under that at around $76 million. So still in line with what we thought for 2024. I think the other important thing to think about is looking at the overall $200 million, we're still confirming our expectations for co-investments in that range over a 3-year period. We did bring down our expectations for 2025.

And I think also the important thing to know is we're really seeing maybe only $1 million to $2 million of tool revenue in the first quarter and probably a similar amount in the second quarter. And a lot of the tool revenue will come from the tools going into our Florida facility in 2025, where the majority was coming into Minnesota in 2024. So given the timing of that project, we're seeing it back-end loaded in the second half of 2025, and that's when the majority of the $40 million to $50 million of tool revenue is expected to be recognized.

Nicolas Emilio Doyle
Needham & Company, LLC, Research Division

Okay. Understood. Very clear. And then I think last quarter, you indicated maybe 4 customers have transitioned to Wafer Services in 2024. And then you kind of mentioned some of the strength you're seeing -- you're expecting in 2025 should be further transition. So have any more transitioned this quarter and visibility on that for 2025, the number of customers transitioning?

Thomas J. Sonderman
CEO & Director

Yes. Well, as I mentioned in my prepared remarks, NanoDX, we just concluded a supply -- long-term supply agreement with them. The timing for when they'll actually move to production like our other customers is highly dependent on their qualification schedules, which are somewhat out of our control. But we continue to be very confident in our conversions, and that's why overall, we're looking at Wafer Services growth next year even in the soft macro environment we're dealing with as it relates to our traditional legacy business, which was really our main driver of Wafer Services as we entered this year.

Operator

Your next question comes from the line of Richard Shannon with Craig-Hallum Capital.

Richard Shannon

Maybe a question on the accrual reversal, the accrual you took in the first quarter, you said you reversed a good chunk of here. I guess how do we think about the potential for a full reversal? And what does that mean about the program involved here? Does this mean we're back to where we were before? Or how should we interpret what this means for that program?

Steve Manko
Chief Financial Officer

Yes. So Richard, this is Steve. I'll start with it on the accounting side, and then I'll give it over to Tom to talk about the program. But just to make sure we're clear, it was an $8 million accrual that was recorded in the first quarter, and we released the remaining $5.6 million of that in the third quarter. So essentially, if you look at that on a year-to-date basis for 2024, it's almost like it never happened. So the full accrual now has been recognized and reversed through the P&L. So from an accounting perspective, it's all behind us.

Tom, do you want to talk about the program?

Thomas J. Sonderman
CEO & Director

Yes. Richard, you on the other side. The way to think of this program, again, it's a technology development program. And when we were exiting Q1, we were working through some technical issues that we have resolved. Really excellent progress by the team to get the platform stabilized so that we can launch it in the second half of next year.

Our PDK will be released in the early part of next year. And while production is still several years away, again, this is our rad-hard program that has a significant qualification beyond just the chip manufacturing, we expect this program to continue to move forward at a pace that is consistent with our customers' expectations, and we really feel good about where we are given some of the challenges we were facing earlier this year.

Richard Shannon

Okay. I appreciate that update. And Steve, thanks a reminder about the prior accrual reversal, I guess I forgot about that one. My second question is really kind of looking at your aerospace and defense customers and you talk about budgets that were a little soft ending the September quarter of the fiscal year for the government. Maybe if you want to discuss both what you're seeing here as an impact in the current fourth quarter, but obviously, as we have a new administration coming in, in the following quarter here, what do you get a sense either way about what this might mean for the programs you're involved with?

Thomas J. Sonderman
CEO & Director

Yes. So we feel very strong about all of our programs. I think as we enter the new fiscal year, which began in Q4, of course, the funding and the commitment to the programs is as strong as it's ever been. And a lot of that has to do with the progress we've been making as the technology development matures.

But the real question related to the administration and all that, that obviously has to work its way through the process. But we're as confident again as we've ever been in our ability to not only execute on these programs, but where they are in their development cycle, and the ability, again, for us to make them successful is really all about execution, and that's what we're focused on.

Operator

Your next question comes from the line of Robert Aguanno with Piper Sandler.

Robert Aguanno

This is Robert on for Harsh. Just one here for me on gross margin. The gross margin trajectory had been growing steadily through the year, and it seems like you guys are guiding it down here for Q4. Can you give us some of the drivers, I guess, looking forward for 2025 since you mentioned in your presentation, increasing revenues and operating leverage kind of impacting here the number for 2025. So I was wondering the puts and takes there.

Steve Manko
Chief Financial Officer

Yes. First off, let me address the fourth quarter. Gross margin isn't expected to go down in the fourth quarter. It's expected to be very similar to what it was in the third quarter, especially when you're looking at it from the tool impact on a basis point perspective. So ATS and Wafer Services revenue levels are expected to be the same in the fourth quarter as they were in the third and also the gross margin driven from ATS and Wafer Services business is likely to be the same in the fourth quarter as well.

With those levels, if you look at margin expectations for 2025, I would expect our margins to increase given the lower amount of tool revenues coming through. Again, we're looking at more like $76 million or so of tools in 2024 compared to $40 million to $50 million in 2025. So your margin on a basis point impact will be less in 2025 given the lower amount of expected tool revenue.

But the ATS and Wafer Services business is expected to grow, as Tom mentioned. And with that, we still believe that we're going to get better than a 55% flow-through at these revenue levels on a margin. And with that, the gross profit should increase in 2025 as well.

Operator

And we have no further questions in our queue at this time. I will now turn the call back over to Thomas Sonderman, CEO, for closing comments.

Thomas J. Sonderman
CEO & Director

Thank you, operator. I want 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, and we intend to continue to build your confidence in our ability to execute.

Please reach out to Claire directly to arrange a follow-up, and we hope to see many of you at the New York Summit in December or the Needham Growth Conference in January. We look forward to providing an update on our 2024 results in February.

And with that, I'll conclude today's earnings call.

Operator
Ladies and gentlemen, this does conclude the call. Thank you for your participation, and you may now disconnect.