Charles Liang, Founder, Chairman, President & Chief Executive Officer

Thank you, James and good afternoon, everyone. Today we have released financial results for our fiscal third quarter 2020. Now let's take a look at a few highlights from our Q3 results.

- Our third quarter net sales totaled $772 million, up 4% year-over-year.
- Our Q3 earnings per share was $0.84 compared to $0.49 last year, which was up 71% Year-over-year.
- One area of particular strength in the quarter was our 5G, Edge and IoT products, which were up more than 30% year-over-year.

Before we dive into the financial details, I want to provide you an update on our business strategy. To make it simple, our business strategy is to build the best products for the right markets, leveraging our unique, building-block-solutions design approach and green computing, resource-saving architecture that's beneficial to both our customers and the environment. We have been focusing on four strategic, high-growth market segments and are aligning our resources accordingly to speed up growth for the coming quarters and years. These four strategic drivers are:

1. Our organic enterprise and channel business, including server, storage and AI, which are our long historic growth areas.
2. 5G, Edge and Telco businesses
3. Large datacenter and public cloud
4. Software and global services

In the enterprise space, we have acquired many brand name enterprise customers over the years, and our strategy is to win more new accounts while growing our install base. To that end, we have our key products such as BigTwin, Ultra and MP systems certified by leading enterprise software partners such as SAP, Oracle, VMware and Red Hat. As an important part of our organic growth, our channel business has remained strong throughout the years due largely to our building block solutions approach that helps our partners create the most optimized systems for their customers.

In the rapidly growing AI and machine learning space, we have established ourselves as a premier AI system provider. We have recently introduced the industry's broadest portfolio of validated NVIDIA GPU Cloud or NGC-Ready systems optimized to accelerate AI and deep learning applications. We see more AI workloads moving towards the edge, where AI inferencing and 5G is converging and driving up demands for our Intelligent Edge products.

Our second growth driver is 5G, edge and telco, which represent an exciting field of opportunities for Supermicro. We have designed a series of new telco and edge-friendly product lines to help our customers build out their 5G deployments, which enable them to transform their existing, proprietary hardware infrastructure to open, software-defined, x86 standard hardware from Supermicro. For example, our pole-mounted, ruggedized IP65 server is perfect for 5G and the outdoor, intelligent edge. We also introduced an optimized, short-depth 2U Ultra SuperServer that provides better features and faster performance, and is ideal for telco and micro datacenter environments. Just yesterday, we hosted a highly successful online event with our technology partner Intel. The 5G Live Forum brought together leading infrastructure and telco companies from around the globe to discuss the latest total solutions for 5G. These sessions are now available on our website. We believe the transition from 4G to 5G will provide Supermicro significant growth opportunities going forward.

The third growth driver we see is in the large datacenter and public cloud space. Our new products, such as the CloudDC systems, are purpose-built for hyperscale datacenters with cost-optimization and ease of volume deployment. In preparation to scale for more cloud business, we have already made available 30% extra production and service capacity as of today and are also expanding our global manufacturing facilities, especially in Taipei, where lower operating costs allow us to be more competitive.

The last and fourth growth driver is our software and global services. To ensure our server, storage and networking products are simple to deploy, easy to manage, and secure to use, we have been investing in our software and global services over the past many years. In addition, we have certified all the major operating systems and key applications while adding more security capabilities. As more and more customers are deploying data centers at increasingly large scale, it’s paramount that we supply them with more capable, cloud-scale management software that enables streamlined and fully automated data center operations. An enhanced mix of hardware, software and services revenue will also improve our gross margin over time and provide revenue stability.

In summary, we were pleased with our quarterly results despite the disruptions caused by COVID-19. At this moment, we do not plan to provide this quarter’s revenue guidance, but we are very excited with our innovative product pipeline and our new growth drivers, which should help Supermicro re-accelerate our revenue growth and resume our long history of market share gain.

I will now hand the call over to Kevin to review the results of the quarter in more detail.

Kevin Bauer, Senior Vice President and & Chief Financial Officer

Thank you, Charles.

First, I would like to thank to our employees, customers, investors and partners for their support as we navigate the challenges during the COVID-19 pandemic.

Upon the news of the outbreak overseas, our first response was to actively manage our supply chain for potential shortage risk by increasing inventories of critical components. Since that time, we have continued to add to our safety stock for key components such as CPUs, memory, SSDs and to a lesser extent GPUs such that customer orders can be fulfilled as they are received.

As a designated essential business, we responded to the directives from Santa Clara County and the State of California regarding “shelter in place” instructions to combat the spread of COVID-19. Our first priority is the safety of our workforce and we immediately began to implement numerous health precautions and work practices to operate in a safe manner.

Operating in the critical sector of IT infrastructure, we assessed our customer base to identify priority customers who also operate in critical industries, guiding us in our go forward strategy. We quickly transitioned most of our indirect labor force to work from home. We also shifted some focus towards Taiwan operations from Europe and the United States. Despite this disruption, we successfully managed the last two weeks of March to achieve revenues at the bottom of our original guidance range.

Now let me turn to the financials:

Our fiscal third quarter revenue totaled $772 million which was at the lower end of our initial guidance range given on February 6 and above the midpoint of the guidance range we gave on April 2. This reflects an 11% quarter-on-quarter decrease from the second quarter of fiscal year 2020 but a 4% increase from the same quarter of last year.

Systems comprised 74% of total revenue and volumes of systems and nodes shipped were down sequentially but up year-over-year. A number of large enterprise customers fulfilled datacenter projects in the December quarter and, is often the case, paused in the March quarters. ASPs increased quarter-on-quarter but declined year-over-year.

Geographic performance on a year-on-year basis was mixed with the US down 3%, EMEA up 20%, and Asia 10% higher. On a sequential basis, the US market declined 20% while EMEA grew sequentially by 9%. Asia declined a modest 3% sequentially.

There were a number of sizable discrete events in the quarter that I would like to emphasize:

- First, we received a settlement fee on a joint product development project for $10.1 million dollars, $0.6 million of which reduced cost of sales and $9.5 million that reduced R&D expense. Applying our US tax rate of 23% would yield a $0.14 benefit to diluted earnings per share on both our GAAP and non-GAAP financials.

- Second, in our last call, we mentioned that we expected to incur additional one-time charges of $35 million to $40 million related to residual clean up matters from our extended blackout period. By direction of our Board of Directors, we sought input in this matter from investors holding approximately 45% of our shares outstanding and incorporated that input to provide cash awards, many of which included performance conditions. This quarter, we recorded $10.3 million in expense, $2.9 million of which increased cost of sales and $7.4 that increased operating expense related to the awards. As noted in our last call, we have excluded this item from our Non-GAAP measures.
- Lastly, we recorded a provision for an SEC settlement of $17.5 million dollars that we have excluded from our Non-GAAP measures.

Working down the P&L, gross margin on a non-GAAP basis was 17.7%, 250 basis points higher than last year driven by lower labor and commodity costs as well as favorable customer, geographic, and product mix and the aforementioned settlement fee.

Q3 operating expenses on a GAAP basis increased 7% quarter-on-quarter to $118 million mainly due to a $12.5 million increase in salaries and benefits including previously disclosed performance awards and related payroll tax withholding and $17.5 million in increased legal expenses. These expenses were offset by $9.5 million related to the termination fee. On a non-GAAP basis, operating expenses decreased 15% quarter-on-quarter and increased 8% year-on-year to $87 million. The sequential decline was due to several factors including lower audit costs and lower employee costs including R&D expenses and the termination fee. Recall, that concluding our delinquent filings in the December quarter led to a sequential reduction of G&A expense by approximately $6.5 million dollars.

Other Income & Expense was a $0.9 million gain as compared to a $0.4 million loss last quarter primarily related to the foreign exchange impact on our Taiwan dollar denominated term loan.

This quarter our taxes were a $0.9 million benefit on a GAAP basis and $2.9 million expense on a non-GAAP basis. In both cases we benefitted from reduced tax liabilities in the US and the Netherlands. We continue to expect our non-GAAP tax rate going forward to approximate 20%.

Lastly, our share of results in a Joint Venture was a $1.1 million loss this quarter as compared to a $1.0 million loss in the previous quarter and a $0.4 million loss in the same quarter a year ago.

Q3 non-GAAP diluted EPS totaled $0.84 per diluted share compared to $0.57 last quarter and $0.49 last year.

Cash used in from Operations totaled $21 million as we invested in Inventory as a defensive measure and Capex totaled $11 million resulting in free cash out flow of $32 million. Our closing cash position was $301 million.

This quarter, our cash conversion cycle was 92 days which is slightly above our target of 85 to 90 days. Days Sales Outstanding was 41 days, Days Payables Outstanding totaled 61 days and inventory days was 112.

Now turning to the outlook for our business. Given the uncertainties of COVID-10, we will not be providing guidance for the coming quarter. However, to help provide context around our business, we are sharing the following metrics and facts:

We continue to see ongoing demand as we enter the fourth quarter of fiscal year 2020 and do not have significant direct exposure to industries such as retail, oil and gas, and travel & leisure that have been impacted the greatest. As time passes, we may discover greater indirect exposure to distressed industries through our channel partners and OEM customers.

We note that our shipments plus orders shippable in the June quarter as of last week are up as compared to the prior quarter and are also up compared to the same quarter a year ago as well.

Looking forward, logistics has emerged as a new challenge as the transportation industry restricts the frequency of departures and increases costs. We expect increased costs in freight as well as direct labor costs as we incentivize our employees to continue to work and assist us in serving our customers, many of whom are in critical industries. We expect these incremental costs to reduce Gross Margin by 100 to 150 basis points on a sequential basis.

We also expect to record expense of $16 to $17 million dollars related to the aforementioned performance awards in the June 2020 quarter. Approximately $20 to $25 million in cash will be paid in the June 2020 quarter related to these performance awards.

Our management team is focused on guiding our company through the unfolding and emerging challenges presented by COVID-19. Although, we are unable to predict the extent to which the COVID-19 may further impact our business operations, financial performance and results of operations, we believe we are well positioned financially and strategically as we continue to serve our customers.