WDC F2Q Benefits from HDD Growth and Flash ASP Strength

WDC	*18 est.*	*Western Digital*		*FY24rev:*	*0%*
Qtr:	F2Q	**Grade:**	*B*	***Growth*** *(qtr-qtr)*	
Rev:	3,032	**Rev:**	++	**Rev:**	10.3%
GM:	15.5%	**EPS:**	+++	**Fcst:**	+6+12%
EPS:	($0.69)	**Fcst:**	+++	**Div:**	$0.50

Western Digital *(WDC $58.23 -2.10 after the close on 1/26/24)*
F2Q Earnings: WDC announced December-end F2Q results after the close on Jan 25 that exceeded expectations and guidance on increasing HDD volume, as well as better than expected flash pricing. Last October the company announced a plan to split into two separate companies, offering HDD and Flash, sometime during 2H of 2024.

F2Q Results: Gross margin of 15.5% improved by 11.4 percentage points sequentially due to higher flash ASPs as the company "proactively optimized product mix." Higher than expected underutilization charges of $156 million cost 5.1 percentage points of margin. Op ex at $561 million was down -15% year-over-year and a $14M convertible preferred share dividend was paid. Operating cash flow was negative -$92M, free cash flow was negative -$176M, and cash cap ex was $84M. WDC issued $1.6B in convertible notes, repurchased $508M of its outstanding 2024 converts and paid down $300M of a term loan. Debt was $8.5B, cash $2.5B, and a revolver of $2.25B was untapped at quarter-end. The $600M balance of the 2024 converts is to be retired in February.

Cloud (*enterprise*) accounted for 35% of revenue and grew by +23% sequentially due to higher nearline (HDD) shipments totaling 67 exabytes primarily to data center customers, and better nearline pricing. Cloud revenue increased sequentially for the first time in six quarters. Client (*PCs*) at 37% of sales declined by -2% as a decline in flash bits was nearly offset by ASP growth. **Consumer** (*retail*) at 28% of sales was up +15% due to seasonal strength in flash bit shipments amid rising prices—and benefited from 'product mix optimization.'

Flash: Flash accounted for 55% of revenue and grew by +7% sequentially as ASPs increased a better-than-expected 10% on a blended basis (and 7% on a like-for-like basis) while bit shipments decreased 2%. Flash gross margin of 7.9% was up +18.2 percentage points sequentially and included underutilization charges of $107 million worth 6.4 percentage points. Flash days of inventory is at a 4-year low and the company has been maintaining annual cost reductions in the mid-teens percent and optimizing capital efficiency through its manufacturing joint venture with Kioxia. Management claims best-in-class gross margin throughout the cycle.

The company is ramping an array of QLC-based client SSDs utilizing BiCS6 technology combined with an in-house controller chip. Next generation BiCS8 technology yield is progressing well.

Hard-Disk Drives: HDDs accounted for 45% of sales and grew by +14% sequentially as total exabyte shipments increased by +14%, units grew by +11% to 5.9Mu, and ASP per unit increased by +9% to $122. Gross margin of 24.8% grew by 190 basis points and included an underutilization charge of $49M, or 3.6 percentage points.

Management claims its ePMR platform and enhanced UltraSMR technology allows it to offer the best TCO (total cost of ownership) of high-capacity drives to cloud customers enabling leading portfolio profitability and share gain over last two calendar years. Nearline demand is expected to continue to improve throughout 2024 and SMR is expected to surpass CMR by 2025. Major customer additions include a third cloud titan in the US as well as hyperscale and smart video customers in China that are currently qualifying 26- and 28-terabyte UltraSMR drives.

New drives combining ePMR, OptiNAND and UltraSMR technologies in the 30/upper 30-terabyte capacity range are expected to be introduced over the next several years. The transition to next-generation HAMR technology is expected at the economic cross-over of 4 terabytes per platter.

Guidance *(non-GAAP):* F3Q sales at $3.2-3.4B, gross margin of 22-24% (including HDD underutilization of $30-40M), op ex of $600-620M up with the reinstatement of incentive compensation, interest expense of $95M, taxes at $20-30M, preferred dividend of $15M, and EPS of $0.05 +/-$0.15 on 330M shares. Revenue is expected to grow mostly from HDD volume and pricing, with flash up slightly as ASP growth more than offsets declining bits.

Too Many Known Unknowns: I was excited about the share price valuation until I compared it to competitor STX. Clearly the shares are being valued as an HDD company rather than a flash memory semiconductor company—hence plans to split the two. While the flash manufacturing joint venture deal with Kioxia has been a complication since the SanDisk/Toshiba days, it will be interesting to see how debt is allocated on the split.

The shares are trading at 1.9-times book value, although tangible book value is negative. On a price-sales basis it is trading at 1.7-times trailing-12-month, 1.5-times expected FY24, and 1.2-times expected FY25. EPS is negative until FY25 where it is trading at a price-earnings multiple of 12.8-times an expected $4.55.

LEGEND

		Grade	
+++	exceeded the high-end of the range		
++	above consensus, within the high-end of the range	A	all +++
+	slightly above consensus	B	all +
o	met consensus	C	all o/+
-	slightly below consensus	D	mixed -/o/+
- -	missed consensus, within the low-end of the range	E	all o/-
- - -	missed the low-end of the range	F	all -

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