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Seagate Technology Plc (STX)

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and welcome to the Seagate Technology Fourth Quarter and Fiscal Year 2020 financial results conference call. My name is Jason and I will be your coordinator for today. At this time, all participants are in a listen-only mode. Following the prepared remarks, there will be a question-and-answer session. As a reminder, this conference is being recorded for replay purposes.

At this time, I would like to turn the call over to Shanye Hudson, SVP, Investor Relations and Treasury. Please proceed, Shanye.

Shanye Hudson

SVP-Investor Relations and Treasury, 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 June quarter and fiscal 2020 year-end 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, a reconciliation to the corresponding GAAP measures is not available without unreasonable effort.

As a reminder, this call contains forward-looking statements, including our September quarter financial outlook and expectations about our financial performance, market demand, industry growth trends, planned product introductions, ability to ramp production, future growth opportunities, possible effects of the economic conditions worldwide resulting from the COVID-19 pandemic, and general market conditions. These statements are based on management's current views and assumptions and information available to us as of today 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 and 10-Q filed with the SEC, our Form 8-K filed with the SEC today, and the supplemental information posted on the Investors section of our website. As always, following our prepared remarks, we'll open the call up for questions.

I'll now 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 will begin the call by summarizing our June quarter performance, giving context for the current market environment, and then share some perspectives on the longer term data trends before turning the call over to Gianluca to discuss details on our June quarter results and provide our outlook for the September quarter. Following the prepared remarks, we will open the call for questions.

Results for the June quarter came in within our guided range amidst the deteriorating demand environment across several key end markets, coinciding with COVID-19-related economic impacts. We delivered June quarter revenue of \$2.52 billion and non-GAAP EPS of \$1.20. We increased free cash flow by 5% sequentially to \$274 million, over 80% of which we returned to our shareholders through dividends and share repurchases, demonstrating our commitment to our capital return program.

I'll address in a few moments why we see the impacts that developed in the June quarter continuing in the September quarter. I'll also discuss why we remain confident that the company will emerge stronger from this current crisis.

It's only been a few months since COVID-19 was declared a pandemic. However, its impact on the macro economy and global society has been profound. Economists predict global GDP will sharply contract this year to a level we've not seen in six decades, which has wide-reaching effects on how businesses are planning and investing near-term.

Additionally, the restrictive measures and business closures have created emotional and financial hardships on people, communities, and businesses. I'm proud of how our team has adapted quickly to this tough environment to continue serving our customers and partners while also supporting our local communities and one another.

As a team, we've donated equipment and supplies to hospitals and healthcare workers, provided funding and support for food banks, schools, and elderly care facilities. We've also leveraged our data science expertise to volunteer resources through our Data for Good program and have granted free access to our patent portfolio in support of the Open COVID Pledge to aid research efforts to diagnose, treat, and ultimately prevent the virus.

For Seagate, ensuring the protection and safety of our employees, customers, partners, and suppliers remains our highest priority and is vital to the continuity of our business. At this point, all of our manufacturing facilities are fully operational and we've worked through a majority of the supply chain and logistics challenges that we had faced early on, although there are cost implications that I will touch on later.

The impact on our customer base has been more varied across our end markets. The increase in remote work and education, as well as acceleration of streaming video, online gaming, and a rapid shift to public cloud, drove ongoing data center investments by cloud service and content providers. These investments spurred strong demand for our nearline products in the June quarter, and we expect these trends to ultimately accelerate the transition to mass capacity storage.

Conversely, economic uncertainty and the extension of restrictive measures began playing out in other markets as the quarter progressed, causing smaller and mid-sized enterprise customers to scale back their IT budgets, municipalities to delay certain projects, and consumers to spend more selectively. These macro-economic factors ultimately impacted sales of our video and image applications, and led to a steeper than seasonal decline for our legacy products.

Amidst this overall environment, we're anticipating a continuation of these demand trends to impact our legacy markets in the September quarter. We will also continue absorbing meaningful costs to navigate the disruptions to normal business operations. These are factored into our guidance for the September quarter.

While there remains limited visibility near-term, the underlying data demand trends have not changed. The rapid growth in data and race for businesses to extract value from that data is fueling the need for more compute and mass storage. Accordingly, we believe current demand patterns will shift favorably as enterprises adjust to the new normal. In the meantime, we're being cautious and carefully managing our cash and expenses to maintain our strong financial foundation.

Seagate has a track record of being good stewards of cash and taking a disciplined approach to managing capital while maintaining the health of our supply chains. We are focused on continuing that track record while staying true to our legacy of returning excess cash flow to our shareholders.

While we've been focused on navigating the tough near-term business conditions, we also made important strides in fiscal year 2020 to place the company in excellent position to capitalize on the world's burgeoning growth in data that is driving secular demand for mass capacity storage and data management solutions.

I'll highlight three key examples. First, despite tough business conditions, we grew both revenue and exabyte shipments in fiscal year 2020, supported by strong demand for mass capacity storage. Revenue from the mass capacity markets increased 25% year-over-year, with exabyte shipments up 57%.

Second, we continue to execute our technology road map. Our fiscal year performance underscores the success of our 16 terabyte nearline drives and launch of our common scalable platform. These drives are now used by the world's leading cloud and hyperscale names.

We target achieving the same success with our 18 terabyte drives. This common platform approach helps to simplify the qualification process for our customers while allowing Seagate to improve operational efficiency.

We began shipping 18 terabyte drives as part of our system solution in the March quarter, with shipments to select cloud customers and channel partners starting in the June quarter. We expect to begin ramping 18 terabyte drives later in the calendar year, which aligns well with market readiness.

We remain on track to begin shipping our first commercially available HAMR drives in late 2020 on 20 terabyte capacities. HAMR technology will be the industry's path to achieving drive capacities of 30, 40, 50 terabytes and even higher. We plan to offer 20 terabyte HAMR drives to customers on a limited basis and as part of our system solution to collect production and field data.

Third, we announced Seagate Lyve Drive, an integrated solution intended to help CIOs cost-effectively move data from endpoints to edge to core. And we launched Lyve Labs, an innovation center to work collaboratively with customers on solutions to their data management challenges. These three accomplishments demonstrate that Seagate is firmly pointed towards capturing market opportunities that are emerging in an ever-growing data world.

Earlier this month, we launched the Rethink Data report, which is based on a survey commissioned with IDC of 1,500 global enterprise business and IT leaders. The findings not only reinforced the massive growth in data, which the study predicts will grow at a compound rate of 42% over the next two years, but also reveals how data is being widely distributed across multiple data centers and cloud environments. We refer to this in the report as data sprawl.

With massive data growth and data sprawl, it comes as no surprise that data management is a top concern among respondents. The emerging role of data ops organizations are intended to address the challenges of collecting, moving, storing, and curating data securely across complex and disparate networks.

Through Seagate's innovative technology road map and broad product portfolio, including our system solutions and evolving Lyve platform, we believe Seagate is the ideal mass storage partner for data ops organizations.

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

Gianluca Romano

Chief Financial Officer & Executive Vice President, Seagate Technology Plc

Thank you, Dave. The business environment in the June quarter remain highly dynamic due to the effect of the pandemic. However, we are continuing to manage the business well while prioritizing the continuous safety of our employees and meeting customer demand.

We continue to see strength in demand from cloud data center customers as they address the transition to a remote economy and migration to cloud services, but we saw weaker than expected demand in our other key end markets, driven by economic uncertainties and business disruption brought on by COVID-19.

Despite these near-term challenges, revenue and EPS were still within our guided ranges and our June quarter performance compared favorably on a year-over-year basis with revenue of \$2.52 billion, up 6% year-over-year and down 7% sequentially; non-GAAP operating margin of 14.8%, up 160 basis points year-over-year and down 70 basis points sequentially; and non-GAAP earning per share of \$1.20 compared with \$0.95 in the year ago period, a 26% increase year-over-year and down 13% quarter-over-quarter.

Additionally, the resilience of our financial model and focus on operational efficiency enable us to generate healthy free cash flow and strengthen our balance sheet.

In the June quarter, we shipped a total of 117 exabytes of hard disk drive capacity, 91 exabytes of the total were shipped into the mass capacity storage markets, that's sequentially, and up from 52 exabytes in the year ago period, representing very strong annual growth. On a revenue basis, mass capacity storage represented 58% of June quarter revenue, and about 63% of HDD revenue, up from 49% of HDD revenue in the year ago period.

Additionally, we achieved our second highest revenue quarter in mass capacity storage in June driven by robust demand of our high capacity nearline drives from a broadening base of cloud and hyperscale customers. Nearline shipments increased to a record 80 exabyte with average capacity increasing to 10.8 terabytes per drive. Our performance was supported by strong demand for our 16-terabyte drives, which remained the company highest revenue product in the quarter.

Looking ahead to the September quarter, we expect soft demand from the OEM and enterprise market as Dave outlined earlier, while cloud data center investment remain relatively healthy. Accordingly, we expect to see some moderation in overall demand for our nearline products near-term. Over the long-term, we believe demand for mass capacity storage in the cloud and at the edge will drive strong revenue growth for nearline products.

Revenue for video and image application declined for the second consecutive quarter, primarily as a result of the evolving health situation. While we saw indication early in the quarter that demand condition were improving, we began seeing municipalities enforcing tighter, restrictive measures and diverting funds toward COVID-19 relief effort, impacting the base of new security and smart video installations. However, video and image application will remain a strong long-term secular growth driver.

Nearly a third of global datasphere growth is projected to come from this and other applications, including data generated from security devices and IoT sensors using smart city and smart factories worldwide.

The legacy market represented 34% of total June quarter revenue, down from 36% in the March quarter. Exabytes shipments into this market declined 9% sequentially to 26 exabytes. The consumer and PC market remained relatively soft during the quarter as anticipated, but a sharper slowdown in enterprise IT spending, particularly among small to medium enterprise customers resulted in weaker than expected demand for our mission critical drives.

We currently expect enterprise IT spending to remain low over the next couple of quarters, which is also impacting demand recovery for our system solutions. Systems are included in our non-HDD business, which represented 8% of total June quarter revenue, up from 7% in the March quarter. In term of absolute dollars, non-HDD revenue was flat quarter-over-quarter, as higher demand for our enterprise class SSDs offset the decline in systems.

To summarize, we sustained strong demand for our nearline products with a broadening of customers. However, sales into the video and image application and mission critical market are being temporarily impacted by the pandemic and led to the sequential revenue decline in the June quarter.

Non-GAAP gross margin was 27.3% in the June quarter, down about 70 basis points sequentially due to lower contribution from the margin of each product that I just described, as well as higher COVID-19 related costs.

These higher costs include underutilization, logistics, worker safety and other labor-related expenses that negatively impacted June quarter gross margin by approximately 130 basis points. As of today, our factories are fully operational. However, we will continue to monitor the current situation, which remain fluid, given the major

impact that the global pandemic is having on our industry, we expect to incur elevated cost for at least the next couple of quarters.

Non-GAAP operating expenses were down 8% sequentially to \$313 million and below our previous plan. In addition to lower expenses reflecting a full quarter impact of working from home, we also incurred certain one-time saving, primarily related to lower variable compensation and benefits.

Separately, we announced a restructuring plan in early June to drive additional operational efficiency. We plan to reinvest most of the savings from this plan back into the business, while also lowering operating expenses by about \$10 million per quarter, relative to our pre-COVID level of approximately \$350 million.

Non-GAAP operating income was \$373 million and non-GAAP operating margin of approximately 14.8% of revenue was in line with our guidance expectation to remain in the upper half of our long-term financial model range of 13% to 16% of revenue. Based on a share count of approximately 260 million share, non-GAAP EPS for the June quarter was \$1.20. We estimate the total impact to EPS from COVID-19 was between \$0.25 and \$0.30, which reflect lower revenue as well as higher cost I previously outlined. We reduced capital expenditure by 12% sequentially to \$114 million in the June quarter, consistent with our plan to align our capital need with the current market environment.

For the fiscal year, CapEx represented approximately 6% of total revenue. Looking ahead, we believe it's prudent to keep our investments around this level given the current market uncertainty over the next couple of quarters. We will continue to work closely with our customer and monitor business conditions as we progress through the calendar year.

We remain focused on cash management and generated \$274 million of free cash flow in the June quarter. We utilized \$55 million to retire approximately 1.1 million ordinary share, exiting the quarter with 257 million shares outstanding. We used \$168 million to fund our dividend and our board also approved a quarterly dividend payment of \$0.65 per share payable on October 7, 2020.

Our liquidity position remains strong with cash and cash equivalent totaling \$1.7 billion at the end of the quarter and access of up to an additional \$1.5 billion through our undrawn revolver. Additionally, we further strengthened our balance sheet by restructuring our debt profile in the June quarter to extend our average maturity level to about seven years and lower our average interest expense. As of the end of the quarter, gross debt was \$4.2 billion with net debt of \$2.5 billion. We now have only around 6% of principal debt coming due over the next two fiscal years.

Inventory remained relatively flat quarter-over-quarter at \$1.1 billion. To better respond to current market conditions, we will continue to proactively build supply for some critical components to mitigate potential supply chain risk in the future, and also plan to increase use of ocean freight to offset some of the elevated freight charges. Reduction would result in slightly higher inventory levels.

As we enter fiscal year 2021, the level of uncertainty remains high, and we cannot predict the timing or shape of an economic recovery. We are now four weeks into the September quarter, and the pace of demand has been slow, a similar pattern to what we saw in both the March and June quarter.

We continue to foresee healthy cloud data center demand over the long term but remain cautious and are now planning for broader market demand to improve this quarter. With this in mind, our guidance reflects an appropriate level of conservatism in our cash management and our production plan.

We expect the following for the September quarter: revenue to be \$2.3 billion, plus or minus \$200 million; non-GAAP operating margin at or slightly below our long-term range of 13% to 16% of revenue; and non-GAAP EPS is expected to be \$0.85, plus or minus \$0.15.

In closing, Seagate is executing well during this period of unprecedented uncertainty. With our robust balance sheet and solid free cash flow generation, we believe Seagate is in a healthy position to navigate the current market while continuing to capitalize on the attractive secular growth opportunities that will play out longer term.

I will now turn the call back to Dave for final comments.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

Thanks, Gianluca. Looking ahead, the near-term outlook is unclear. However, we will continue to execute on what is in our control. We have an agile business model, strong balance sheet and ample liquidity that we believe allows us to operate efficiently and intelligently through stressed business environments.

We will manage our cash carefully while maintaining our commitment to return at least 50% of our free cash flow to our shareholders. As I covered at the top of the call, a bright spot through the course of this year has been the strong performance of our mass capacity portfolio.

Mass capacity now represents 58% of the Seagate's revenues, up from 46% one year ago and 24% five years ago. This pivot has been intentional and has powered Seagate's resilient performance through the first leg of this crisis.

Going forward, we remain confident that our strategic focus on mass capacity storage and data management solutions is the right one and that long-term trends tied to data growth will continue to drive secular demand for these products, both in the cloud environment and at the edge.

We anticipate demand across our end markets to improve within the next six months and currently model revenue to be fairly flat in fiscal year 2021, supported by the strength of our mass capacity product portfolio.

Reiterating the outlook we provided at our analyst event last year, we believe the mass capacity storage TAM will nearly double over the next five years, growing from approximately \$12.5 billion in the last 12-month period to around \$24 billion by calendar year 2025.

The innovation of our technology road map and product pipeline makes Seagate well-positioned to capture these opportunities, grow revenue, and drive strong free cash flow over time.

While the mass capacity opportunity alone is sufficient to drive solid growth over this medium-term horizon, it's worth noting that we also expect the edge data opportunities and legacy markets to meaningfully contribute to revenue and cash flows as well.

Prior to opening the call for questions, I want to briefly address the important movement underway to finally drive much needed racial injustice reforms. As a company guided by the core values of innovation, integrity and inclusion, this is a vital moment for us to set a leading example with all of our stakeholders.

We acknowledge that we do not have all the answers, but we are committed to taking this opportunity to look inward and create positive change across our global organization. We have already taken actions to raise awareness, open lines of communication, expand our training and further our inclusion efforts.

Inclusion is foundational to our success and extends beyond our employee base. And I'm looking forward to this opportunity to make Seagate even stronger. My confidence in Seagate's potential is reinforced by the determination of our people, the support of our diverse supplier base and the strength of our relationships with partners and customers.

With that, Gianluca and I are happy to take your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Katy Huberty from Morgan Stanley. Your line is open.

Kathryn Lynn Huberty

Analyst, Morgan Stanley & Co. LLC

Q

Thank you. Good afternoon. I think I heard Gianluca say that you expect moderating growth in nearline in the September quarter. If that's right, how should we think about the sequential drop in nearline exabyte shipments? And as a follow-on to that, is there any visibility at this point into whether there would be a recovery in exabyte shipments going into the December quarter?

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

A

Yeah. Hey, Katy. I think we've been on a tear. Of course, year-over-year, we talked about 57% growth in exabytes. As far as I can see, the period that's going on, we continue to see large growth. And Gianluca can quantify it from here.

But from my perspective, these digestion periods that people have been talking about is really quite different. It's more of a race to get things online. And that's what we see. So there's a fairly strong demand. We expect that that strength is going to continue up throughout the rest of the fiscal year.

We don't really have visibility into the customers' inventory levels but believe any disruptions are just very temporary, at least the cloud service providers. More of the thing that have affected nearline all in was a smaller portion of the nearline, which is the, I'll call it, on-prem enterprise.

So that's the small, medium business enterprise, that's the impact is. And we're expecting that to slightly recover or start its recovery, but some of that was just because in Q4 and going into Q1, small, medium businesses are not really registering very much.

So over the long term, there's big data growth trends. Even in on-prem where people aren't necessarily buying right now, there's anecdotal evidence that utilization rates are going up of the capacity. So data is growing everywhere that on-prem part to watch right now. And we do expect some recovery over time.

I don't think you should take away from our comments that cloud is softening or anything else. If anything, cloud is racing to get everything online and meet their service level agreements. Sorry, Gianluca.

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

A

Yeah. I would say, first of all, we had a record quarter in FQ4 so we see a very high starting point in terms of exabyte volume. What we said in the script is we will not see the same level in FQ1. We don't expect to see the same level in FQ1.

But over the long-term, for sure, we expect this need for data to be there and to continue to drive this secular growth. And so we are very confident with the long-term situation. And even Q1, maybe it's not the level of FQ4, but it doesn't mean that is a very low level for the quarter.

Kathryn Lynn Huberty*Analyst, Morgan Stanley & Co. LLC*

Q

Okay. Thank you.

Operator: Your next question comes from the line of Patrick Ho from Stifel. Your line is open.

Patrick J. Ho*Analyst, Stifel Financial Corp.*

Q

Thank you very much. Maybe, Dave, as a follow-up to Katy's question regarding nearline drive and the demand trends. Just given that overall data center and cloud spending does remain healthy right now, what's the timing between purchases of drives versus, say, servers and memory products that are seeing strong demand? Is there a little bit of a lag time when storage purchases are made after those server buys are completed?

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

A

It's a very interesting question. I think back to my point about digestion periods to expand on that whole topic, Patrick, the past digestion periods might have been more around storage optimization of software in the datacenter and things like that.

I think right now, to your point, in order to meet the service level agreements, as everything has been pushed into the cloud, the cloud service providers generally have really tough challenges responding on all fronts with whether it's network gear or servers to meet compute requirements for people that are using the compute aspects. And then I think storage does lag that a little bit, but the data is growing as well very quickly in those service level agreements.

And so generally speaking, I think there's a race to get everything online. It's not really a typical digestion period characterized by software. And I think that this push that you've seen from the client server models quickly into the cloud models is ultimately good for mass capacity.

It's just we have to – back to the answer to Katy's question, we have to make sure that we're satisfying this demand as it's growing very quickly and then make sure that we are patient with the on-prem demand because the on-prem right now is kind of stagnating.

Patrick J. Ho

Analyst, Stifel Financial Corp.

Q

Great. Maybe as a quick follow-up, you talked about the release and the introduction of the 18-terabyte drive and the common platform, which is very beneficial for a lot of your customers that are already on the 16-terabyte platform. How do you drive "new customer wins" and continue the share gains that you've achieved over the past year with the 16-terabyte as you move to 18-terabyte?

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

A

Yeah. Thanks. I mean, we think about serving the customers and what they need. So for those customers that are still maybe ramping 16TBs and not buying 18TBs yet, we'll continue ramping them on 16TBs. Some people want to make the transition. And I think we're ready to go. So we have a lot of confidence on that platform now because we're deep into the platform. But we can also make the necessary changes that we want, which are fairly minor to get to 18 terabytes. And remember that this same platform allows us to go back down to 12TBs and 14TBs and all the other things. That's one of the reasons we drove it so hard.

I think the pipelines around all those products relative to customer qualification and availability are quite good. We have great dialogues with the customers and when they want to pivot, we'll pivot.

Gianluca Romano

Chief Financial Officer & Executive Vice President, Seagate Technology Plc

A

Yeah. I would add to that. We manage the business for the long-term, not really focusing on the short-term market share. The market share is an outcome of our good product and how we manage the business. But it's not, that is our top focus for the short-term. We always focus on free cash flow, as Dave was saying before, and profitability.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

A

One other thing we said in the prepared remarks, to take you back about four quarters or so as is at a time like this, you make sure that you watch your cash really carefully and that means we watch – what I've learned over time is watch production. So don't build in anticipation of some of those things, stay really tight with your customers and build exactly what they need. I think that's the best way for us to watch our cash, and that's what we'll continue to do.

Patrick J. Ho

Analyst, Stifel Financial Corp.

Q

Thank you.

Operator: Your next question comes from the line of Ananda Baruah. Your line is open.

Ananda Baruah

Analyst, Loop Capital Markets LLC

Q

Hi. Good afternoon, guys. Thanks for taking the question. Hey, Dave, Gianluca, just to start, a clarification or I guess maybe just a little bit more on what you're expecting sort of demand-wise as we go to fiscal 2021. On nearline hyperscale, do you think that we've reached the peak exabyte ships in the June quarter? Or as sort of digestion period ends, do you think we could sort of revert back and go above 80 exabytes over the next few quarters? And, Dave, it feels like maybe that has to happen to be able to hit flat growth given the September

quarter guidance. And then also along with that, any detail or any context in that flat outlook, how you're expecting or sort of accounting for on-prem to bounce back as well? And then I have a quick follow-up. Thanks.

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

A

Yeah. Yeah. That's good. I think it is a question between on-prem. If you break down nearline between cloud service providers, which I said was a little bit more than 50% and that changes quarter-over-quarter. And then you have the rest of nearline which is on-prem. I think on-prem is the thing to really watch. So the near-term is fairly uncertain like we talked about, and we do need the on-prem to come back, it will. And that's my point about utilization levels.

I think as far as the data everywhere is growing very healthy and the demand for data is exploding with all the IoT and smart cities and autonomous vehicles and all that stuff that's going on. And to take advantage of that, the cloud service providers are going to have to put a lot of stuff online. I think there's also a lot of on-prem opportunities. So long term, we feel more certain, but it's this near-term period of small, medium businesses, people can't get in. Or even if they can, they've got other priorities right now that we've got to just get through that period.

Ananda Baruah*Analyst, Loop Capital Markets LLC*

Q

And, Dave, do you – to hit that – sorry, Gianluca. Go ahead.

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

A

You were asking about a little bit longer-term outlook. And in the prepared remarks, we are seeing that for fiscal year 2021 we are looking right now at a revenue that is fairly flat with fiscal year 2020. Of course, there is an impact from the COVID situation. So our assumption is based on an impact from COVID that will start to decline in the next few months. But now, we are still very, very confident in Seagate outlook over fiscal year 2021 and on the long-term.

Ananda Baruah*Analyst, Loop Capital Markets LLC*

Q

And do you think nearline – or I'll just say nearline, overall, do you think it reaches – it gets above 80 exabytes, does it need to get above 80 exabytes as we go through the fiscal year to hit that flat revenue outlook?

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

A

Yeah. I think the other mass capacity markets like surveillance and NAS, they come back on and they start moving to higher and higher capacity points, I think you'll see the exabyte growth. So we need those more on-prem type of mass capacity applications, on-prem, I'll say, private data center applications. We need those to grow in exabytes and come back, but we think that will happen and then you'll see exabyte growth again. Yeah.

Ananda Baruah*Analyst, Loop Capital Markets LLC*

Q

Got it. Got it. Great. Thanks, guys.

Operator: Your next question comes from the line of Shannon Cross from Cross Research. Your line is open.

Shannon Cross

Analyst, Cross Research

Thank you very much for taking my question. I was curious on cash flow. You talked about some insight into flat revenue for next year. How should we think about cash flow opportunity to drive maybe some working capital improvement? Thank you.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

Thanks, Shannon. I'll let Gianluca answer this. But loosely speaking, we have quite a few levers to pull, should we need to. And from my perspective, cash flow is exactly what we're driving right now as the metric. We're watching our cash very carefully. Like I said before, not bringing on too much inventory, although, we do have to make sure that we cover potential factories being down. That's the reality of where we were last quarter and that may still happen again. So we have a little bit more inventory, but we're going to watch our cash very carefully, not overbuild, make sure that we're running things the right way. We're still making investments in ourselves, and we're still bringing in quite a bit of capital as we did last quarter. But I'll let Gianluca talk about more color.

Gianluca Romano

Chief Financial Officer & Executive Vice President, Seagate Technology Plc

Yeah, completely agree. We have generated a very strong free cash flow in fiscal year 2020, and we said we are expecting a revenue that is comparable. And probably, the free cash flow will also be comparable. CapEx, we are investing for the growth that we are expecting in the long term. But, in general, no, I would say, free cash flow should be fairly similar year-over-year.

We have – in term of shareholder return, we have a commitment to return at least 50% of our free cash flow to shareholder. And this is done in the form of dividend and in the form of share buyback. So, we will continue with this policy, and we expect another fairly strong year in term of free cash flow.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

Yeah. And we don't look at it as a tactical discussion either. It's more – we'll manage the cash tactically, but the shareholder return is more long term. That's who we want to be.

Shannon Cross

Analyst, Cross Research

Thank you.

Operator: Your next question comes from the line of Kevin Cassidy from Rosenblatt Securities. Your line is open.

Kevin Edward Cassidy

Analyst, Rosenblatt Securities, Inc.

Yeah. Thanks for taking my question. On the video and image business and applications, can you say – is it all COVID related that they're not being deployed and is there a buildup of maybe some anticipated deployments as

soon as the COVID is released or there's a virus immunity? Are you expecting a surge in that business or is it going to be more gradual?

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

A

It is a really interesting space to watch, I think, Kevin. So loosely speaking, these are on-prem applications and people just couldn't get on-prem. And even if you could, sometimes, there's nobody else there to be on-prem to surveil or whatever, you would say, right?

So it's not surprising to see that these markets were down. They are starting back up again, sputtering to start, but starting back up again. We believe long term that these products are actually quite strong because of smart cities and smart factories and smart hospitals. And so we believe these on-prem applications will come back fairly strongly.

Timing is everything, and we believe we have the best product portfolio to go satisfy that. It will probably grow in capacity points. One of the earlier questions, there's more exabytes coming this way. So the trend that we saw in the last couple of quarters with surveillance, in particular, being so far down is not going to continue. We think it will start ticking back up. There are some early indications this quarter that it's coming back to life and it's geographically very dispersed.

Of course, there's lots of different regions of the world where people are going to be doing this spending. But that's what we see. It should start to improve quarter-over-quarter to this quarter. Don't know how fast it will improve into Q2, but it's certainly a market that, long term, we're watching.

Kevin Edward Cassidy

Analyst, Rosenblatt Securities, Inc.

Q

Okay. Thanks. And just for a little more detail, what's the drive capacity for those systems?

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

A

Typically, in the past, it's been 4-terabytes. Now, it's going up to 6 and 8 terabytes. And so that happens as a function of these technology transitions. So all the while that the markets are going through what the markets are, there's a march towards higher and higher capacity points because there's more value in those drives out in the edge.

Kevin Edward Cassidy

Analyst, Rosenblatt Securities, Inc.

Q

Okay. Great. Thank you.

Operator: Our next question comes from the line of Steven Fox from Fox Advisors. Your line is open.

Steven Fox

Founder & CEO, Fox Advisors LLC

Q

Thanks. Good afternoon. I have two questions, if I could. The first one is you touched on some of this, but I was wondering, Dave, when you talk about getting to flat revenues for the full fiscal year, you start off in about a \$300

million hole, and you've talked about some pressures that in the back half of the year could still be there. So how would you map out sort of a recovery so that the full year is roughly flattish?

And then as a second question, going back to the COVID-related costs that hurt the gross margins by 70 bps, what surprised you most in the quarter that you weren't prepared for? And did the underutilization have anything to do with just the missed top line or is that related to specific manufacturing issues? Thanks.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

A

I'll let – Steven, I'll let Gianluca take the latter part first.

Gianluca Romano

Chief Financial Officer & Executive Vice President, Seagate Technology Plc

A

Yeah. So in general, for the impact of COVID in the quarter, we've said 130 basis point. This is only related to the direct cost. It's not related to the lower revenue that was actually not generated and impacted by COVID.

So in the script, we said the direct cost, about \$35 million or the 130 basis point and then we also said when you look at EPS, you have a second impact. And the second impact is related to the lower revenue and, of course, the margin of those revenue and we quantified for a total EPS impact of between \$0.25 and \$0.30. So at the level of EPS, you have a fairly huge impact in the quarter from COVID.

In the prior quarter, we had the additional cost that were a little bit lower but still significant, about \$25 million. We didn't have a lot of revenue impact. We probably had some impact on the legacy part of the business, but cloud was probably offsetting that reduction.

In fiscal Q4, compared to what we were expecting, nearline came out at the level we were expecting but we had some impact on the legacy business and also on surveillance. So overall, we lost some EPS because of the lower revenue.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

A

And I'd say, to your question, Steven, about the longer term going out throughout the fiscal year, some of the legacy markets have been very slow of late. We don't anticipate – there's some natural decline year-over-year because they are, by nature, legacy. We're not investing in them and we're watching them develop. But I think some of them are temporarily down and they'll come back to some level as previous.

It's a good business for us with good free cash flow and minimal incremental investments that we have to go make. So we'll watch that and some of them have already shifted to flash like notebook and gaming and things like that but there's things like mission critical, which we expect to come back to some level.

The other part of I'll call it on-prem that we talked about before, on-prem nearline has actually been fairly slow as well, satisfied via some of the same channels that we have, but that will come back because data is growing at the edge and in private data centers and things like that. So there's this enormous shift in locality going on between client server business and cloud business. It doesn't mean all client server is gone. It's just some of it's on temporary hiatus and that's what we're expecting to recover somewhat, if you will, to make up the fiscal year guide.

Steven Fox

Founder & CEO, Fox Advisors LLC

Great. That's really helpful. Thank you.

Q

Operator: Your next question comes from the line of Aaron Rakers from Wells Fargo. Your line is open.

Q

Yeah. Hi, guys. Thank you for taking the question. This is Michael on for Aaron. I just had a quick one on pricing. Could you guys comment a little bit on what you saw in the pricing environment, particularly on the mass capacity side? And then I'm just curious how you're thinking about that going into the back half of the year as one of your big competitors begins to ramp 18 terabyte? Thank you.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

Yeah. As far as what we saw in the rearview mirror, I think that getting the right supply to the right places, we had the long plan. We've talked about this with our 16 terabytes, big volumes for most of the mass capacity people. I don't think prices were unpredictable by any means for us. I mean, they were fairly predictable.

I do think that out in some of the distribution channels where the supply-demand picture isn't so clear, early on, there were some supply gaps. Later on, there were some demand – there are demand problems to those on-prem enterprise, especially in the smaller distribution markets. I think that's where you can see a lot of dynamics. From our perspective, that should stabilize pretty quickly because supply is there so – do you want...

A

Gianluca Romano

Chief Financial Officer & Executive Vice President, Seagate Technology Plc

Yeah. If you compare to a couple of quarters ago, for sure, the pricing environment is more stable. So it's a better situation right now.

A

Q

Perfect, thank you. And one more, if I could, just on the OpEx, given that you guys outperformed during the current quarter, how should we think about OpEx in the September quarter relative to June and then also kind of the \$340 million level that you had communicated previously? Thanks.

Gianluca Romano

Chief Financial Officer & Executive Vice President, Seagate Technology Plc

Yeah. So what we were saying in the script is longer term. Probably you want to model around the \$340 million. This is probably after the COVID impact and when people will not be obliged to work from home. For the September quarter, we'll be probably in the mid between what we reported for FQ4 and this long-term view.

A

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

I think there's two elements. Obviously, there are some things that you save money on in the current work environment and then the other thing is that there is very tight cash management, like investments are really

A

being scaled back for us right now and so I think it should re-equilibrate, like Gianluca said, to about that \$340 million level. That's the way you should think about it longer term.

Q

Perfect. Thank you.

Operator: Your next question comes from the line of C.J. Muse from Evercore ISI. Your line is open.

C.J. Muse

Analyst, Evercore ISI

Q

Yeah. Good afternoon. Thank you for taking the question. I guess my first question is on gross margins, both short-term and long-term. So I guess short-term, can you walk through what you're seeing in terms of under absorption, COVID-related costs, and perhaps competitive pressure as you look at September quarter? And then longer term, this is not easy stuff to make and there's three players. This should be a 40-plus percent gross margin business.

So as you think about that, I'm assuming you agree with that assessment, what gets you there? Is it volumes? Is it higher price points on next generation technologies? What gives the earnings power for the industry to the level that is consistent with the technology being proffered?

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

A

Yeah. I'll let Gianluca walk you through the details of the gross margin impacts last quarter. But to your point, actually where the quarter ended up last quarter, we feel pretty good about our gross margin. Our operating profit was above the midpoint of our range of about 14.8%. Gross margins, had we not had some of the COVID impacts which Gianluca can walk through what they were, then we probably would have been in the gross margin range as well.

To your point, supply and demand balance is usually the way I answer that question. Demand for exabytes will continue to grow and we have to put capacity online to go get that. In times like this, we were actually putting capacity online for growth in exabytes and we've got a temporary lull in some of the legacy markets right now so we have excess capacity. So that's not a long-term trend. That's a short-term trend. But to your point, managing supply and demand properly is the way that you add that value. Go ahead, Gianluca.

Gianluca Romano

Chief Financial Officer & Executive Vice President, Seagate Technology Plc

A

Yeah. For the June quarter, we said that COVID-related impact in term of gross margin percentage was 130 basis point. So if you look at where we closed the quarter at 27.3%, you add the 130 basis point, we are 28.6%. As you know, the hard disk part of the business as a gross margin that is a little bit higher than the full corporation.

So I will say, as Dave said before, we are close to the normal or the assumed range of 29% to 33%. For the September quarter, we have said the COVID cost to be fairly flat sequentially. So I would probably model same level of cost.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

Thanks, C.J.

A

C.J. Muse

Analyst, Evercore ISI

Thank you. If I could add one quick follow-up. Can you help modeling with stock-based comp, interest expense, and tax rate? Thank you.

Q

Gianluca Romano

Chief Financial Officer & Executive Vice President, Seagate Technology Plc

Sorry, can you repeat the question?

A

C.J. Muse

Analyst, Evercore ISI

As you look at September, can you help us model interest expense, stock-based comp, and the tax rate?

Q

Gianluca Romano

Chief Financial Officer & Executive Vice President, Seagate Technology Plc

Yeah. I would say stock-based comp is a little bit lower than \$30 million and the tax rate is mid-single-digit and the interests are very similar to the FQ4. So you can just take that as a reference.

A

C.J. Muse

Analyst, Evercore ISI

Thanks so much.

Q

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

Yeah. Sorry, C.J., one other point is just to make sure that you register this, from a gross margin percentage perspective, we're not really running the business like that right now. So if we see deals for cash, we'll take it. I mean – and we were able to increase free cash flow by 5% last quarter, which is ultimately our focus. Just some of the legacy businesses might recover faster, even if it's not great gross margin percentage, we'll take the cash.

A

Operator: Your next question comes from the line of Karl Ackerman from Cowen. Your line is open.

Karl Ackerman

Analyst, Cowen & Co. LLC

Thank you. Good afternoon, everyone. First of all, I want to get your longer term view on not just the mix of your hard drive units between enterprise and non-enterprise but also the absolute level of units for the industry.

I know you and peers have eschewed units over exabytes for some time, would your capital expansion plans factor a resumption of unit growth over the next several quarters? I ask because the last restructuring action taken by the industry was contemplated in late 2018 when the hard drive TAM was annualizing near 400 million units. In C Q2, that number appears closer to 240 million.

Q

Now clearly, COVID has materially disrupted the supply chain and demand, as you described. But I guess how do you think about the capital allocation and OpEx longer term as it relates to stable or most likely improving hard drive volumes and a mix toward nearline?

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

A

Yeah. I think from a space perspective, if I think there first, I think we have plenty of space. What's subtle underneath this is obviously the nearline drives have a lot more heads and disks. And so the heads and disks space is full, the number of drives we make is actually not so relevant in the space that we have. I mean our manufacturing line footprints are pretty small so we could pivot up in number of drives if we had to exactly to your point. I don't know if we'd cut a lot of space if we had necessarily fewer drives, depends on how many fewer, of course.

And from our perspective, almost all of our CapEx has really been pointed at that exabyte growth that we're expecting in the cloud. You believe \$24 billion of TAM out in 2025, we've got to get the right capacity online that looks like heads and disks, and that's the way we're filling things up and using our capital for that as well.

And I think one other point is even the big drives. In the old days, you had a test floor and a clean room. Today, you have 10 test floors and a clean room. The test is actually the thing that's consuming most of the space and most of the capital, and that's all associated with nearline as well. Mass capacity as well.

Karl Ackerman*Analyst, Cowen & Co. LLC*

Q

Very helpful. Thank you.

Operator: Your next question comes from the line of Toshiya Hari from Goldman Sachs. Your line is open.

Toshiya Hari*Analyst, Goldman Sachs & Co. LLC*

Q

Good afternoon and thank you very much for taking the question.

Gianluca, I just wanted to go back to gross margin. You talked about there being a 130-basis point impact from COVID in the quarter. I was curious, what level of impact was initially embedded in your thought process when you gave guidance three months ago? And I guess, importantly, I guess in response to C.J.'s question, you mentioned that you expect relatively flattish COVID impact in the September quarter. But at what point do you think at least some of the underutilization rate headwinds start to abate in your business? And then I've got a quick follow-up. Thank you.

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

A

Yeah. In the guidance, we included a COVID impact slightly above what we had in the prior quarter, so, let's say, between \$25 million and \$30 million, so not very far from where we ended up. And, yes, for September, we expect the cost to be very similar. It's a full quarter impact and so we expect more or less the same amount.

We don't know exactly when this will end and what we have modeled internally is of COVID to continue to have a heavy impact in FQ1 and F Q2, and not much in the second part of the fiscal year. But of course, this is a model

and we don't know exactly what will happen. So but there's an impact also in the demand, so not only on the cost. But the other part of that is maybe even more important, at this point, is demand and the impact on our mix.

So, overall, you need to look at the cost and the demand and the final EPS impact. For FQ4, we have estimated that overall impact to be between \$0.25 and \$0.30. That is a huge impact when you consider our EPS result for the quarter.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

A

And it kind of points to the products, especially the on-prem enterprise products, nearline, mission critical, and some of the surveillance. That mix is fairly rich, heads and media rich, and actually these are tough drives to make as well. So that would have been accretive to gross margin, I think, is the point.

Gianluca Romano

Chief Financial Officer & Executive Vice President, Seagate Technology Plc

A

It's very hard to estimate, very hard but not so we'll – we'll tell you what we have in our model. We don't pretend to be correct.

Toshiya Hari

Analyst, Goldman Sachs & Co. LLC

Q

Got it. No, that's super helpful. Thanks for the color. And then as a quick follow-up, this one's probably for Dave.

I think historically, you guys have talked about a 35% CAGR in terms of exabytes for your mass capacity business. Obviously, you grew significantly north of that in fiscal 2020. Within the context of the flattish revenue outlook you provided for fiscal 2021, are you expecting exabytes in mass capacity to be sort of consistent with that 35% or given the outperformance in fiscal 2020, should we be prepared for a slightly slower growth rate? What are your thoughts today based on your customer conversations? Thank you.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

A

Yeah. Yeah, thanks, Toshiya. I think it'll probably be above the 35% to 40% range. I mean, certainly in calendar year 2020, we've said that we expect to be greater than that and if you call that the slow part even with the mass capacity, then they'll still be – that's the front end of the year. I think as we come out of the back of this, I think it'll – the exabytes will accelerate as well.

So this is why we've made this pivot. I think it kind of proves that it's the right pivot of our portfolio. It's why we want to get our product lines really tight and very manufacturably be flexible and get the right margins in there. So, to your point, I think we'll outstrip the 35% to 40% certainly in calendar year 2020 and probably throughout the fiscal year.

Toshiya Hari

Analyst, Goldman Sachs & Co. LLC

Q

Thank you.

Operator: Your last question comes from the line of Dustin Scaringe from Robert Baird. Your line is open.

Dustin Scaringe

Analyst, Robert W. Baird & Co., Inc.

Q

Hi. Thanks for taking the question right at the end. This is Dustin speaking for Tristan. Just a quick one on 18 terabyte. I know you guys talked about ramping it in the later part of this year but I'm wondering at what point does 18 terabyte cross over 16 terabyte in the future? And then do you expect to gain market share until then? Thank you.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

A

Yeah. It's an interesting question, Dustin. I'm not being cavalier with it, but I'll say we'll cross over when we're ready and when the customers are ready. And I think when we have such high volume on the 16TBs and people are demanding the 16TBs, I think we have to be careful to make sure that we don't, again, build the wrong product at the wrong time for people. We can transition to the 18TBs fairly quickly. I think we do need some lead time because that's heads and media starts and whatnot.

But I think we have great relationships with the big customers that would be demanding that. We're lockstep with them on what those transitions would look like, and I have a lot of confidence in the drive. I don't think it's going to be the significant revenue contributor certainly in the next two quarters, like we said before. But we can transition whenever the customers are ready and we'll take their cue on it.

Dustin Scaringe

Analyst, Robert W. Baird & Co., Inc.

Q

Okay. Thanks for that, Dave.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

A

Okay.

Operator: I will now turn the call back to management for closing remarks.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

Yeah. Thanks, Jason. I'd like to take an opportunity to just thank our customers and suppliers, employees, and investors for their support of Seagate and we look forward to updating you on future calls. Thanks, everyone.

Operator: That concludes today's conference call. You may now disconnect.

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