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DLB.N - Q2 2024 Dolby Laboratories Inc Earnings Call

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Company Summary

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Dolby Laboratories conference call discussing fiscal second quarter results. (Operator Instructions). Afterwards, you will be invited to participate in a question-and-answer session. (Operator Instructions). As a reminder, this call is being recorded Thursday, May 2, 2024. I would now like to turn the conference over to Mr. Peter Goldmacher, Vice President of Investor Relations. Peter? Please go ahead.

Peter Goldmacher

Good afternoon. Welcome to Dolby Laboratories Second Quarter 2024 Earnings Conference Call. Joining me on the call today are Dolby Laboratories CEO, Kevin Yeaman; and Dolby Laboratories CFO, Robert Park.

As a reminder, today's discussion will include forward-looking statements, including our fiscal 2024 3rd quarter and full year outlook and our assumptions underlying that outlook. These statements are subject to risks and uncertainties that may cause actual results to differ materially from the statements made today, including, among other things, the impact of macroeconomic events, supply chain issues, inflation rates, changes in consumer spending and geopolitical instability on our business.

A discussion of these and additional risks and uncertainties can be found in the earnings press release that we issued today under the section captioned Forward-Looking Statements as well as in the Risk Factors section of our most recent quarterly report on Form 10-Q. Dolby assumes no obligation and does not intend to update any forward-looking statements made during this call as a result of new information or future events.

During today's call, we will discuss non-GAAP financial measures. A reconciliation between GAAP and non-GAAP financial measures is available in our earnings press release and in the Interactive Analyst Center on the Investor Relations section of our website. With that, I'd like to turn the call over to Kevin.

Kevin J. Yeaman - *Dolby Laboratories, Inc. - President, CEO & Director*

Thank you, Peter, and I want to thank everybody for joining us on the call today. Revenue for the quarter came in right about where we expected. Earnings came in better than we expected, and our guidance for the full year remains unchanged. Robert is going to share a few of the details with you for the second quarter, and he's also going to speak to third quarter guidance in just a few minutes.

Today, I'd like to cover 3 topics. First, I'm going to make some comments on the macro environment. Second, I'll share some insights into our business. And third, I'll wrap up my portion of the call with some brief closing thoughts. So let me start with the macro.

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We haven't noticed any big changes, but it does remain a tough environment for many of our OEM partners. Following strong growth in fiscal '21 on the strength of pandemic purchasing, device sales have been down each year since, and the resulting declines in foundational revenue have overshadowed strong growth in Dolby Atmos, Dolby Vision and our imaging patents.

Now the upside of this dynamic is that when device sales recover, and we do expect device sales to recover, it will have a noticeable positive impact on revenue and margins. Our foundational technologies make up about 2/3 of our highly profitable licensing revenue and about 60% of our total revenue.

The macro isn't having the same impact on Dolby Atmos and Dolby Vision because growth is coming from getting our technology on more devices, which we are doing, especially in areas like auto. Sales cycles haven't changed noticeably engagement remains very strong, and the amount of content continues to grow, especially true in sports this quarter. Industry adoption as measured by growth in content created in Dolby Atmos and Dolby Vision remains an important lean indicator of future device sales with Dolby Technology.

So even as the general economic environment remains somewhat underwhelming, we remain optimistic about our prospects over time. We continue to target foundational to return to low single-digit growth and Dolby Atmos, Dolby Vision and imaging patents to grow in a 3- to 5-year CAGR between 15% and 25%.

So let me turn to some comments on Dolby Atmos and Dolby Vision, where the 3 most powerful growth drivers are mobile, TVs and auto. I'll give you a brief update on each of these opportunities.

Starting with mobile. We have a compelling value proposition with Dolby Atmos and Dolby Vision for our mobile device providers. And most of these providers are already users of our foundational technologies. We see a meaningful and a durable opportunity to continue to expand our relationships to include value-added offerings such as Dolby Atmos, Dolby Vision and Dolby Vision Capture. We see the greatest adoption of Dolby Atmos and Dolby Vision at the high end. In the second quarter, we announced a number of partnerships. OPPO introduced 5 new phones with Dolby Vision Capture. Xiaomi announced new models with Dolby Atmos and Dolby Vision and Honor also announced new models with Dolby Vision. As it relates to the affordable end of the market, we had some nice wins. Lava Mobile in India and Chinese phone maker Transsion, both introduced more affordable phones with Dolby Atmos.

So let me turn to TVs. We are very excited about Max's announcement that it will be streaming all of its live sports in Dolby Atmos and Dolby Vision in the U.S. This is good for TV and sound bar adoption. In the same way that streaming movies in Dolby Atmos and Dolby Vision catalyze device sales like TVs and sound bars from viewers looking for the most immersive movie experience, we streaming sports and Dolby Atmos and Dolby Vision will have a similar impact.

Max is the first streamer to offer all of their live sports content, including baseball, hockey and basketball in Dolby Atmos and Dolby Vision, and their introduction has led to interest for high-quality content from other partners. And our sports content isn't limited to the U.S. The Indian Premier League will be broadcasting Cricket in Dolby Atmos and Dolby Vision for the first time this year. And there is an ever-growing slate of global sports content in the Atmos and Dolby Vision, including tennis, rugby and soccer.

The more high-quality content that's available in the market, the higher the likelihood that consumers will want to purchase devices that can deliver the best experience. We are particularly excited about the Olympics and the European Championship soccer this summer.

Moving on to automotive. The pipeline of new partners remain strong, and our current partnerships continue to grow. We're seeing growth from new partners shipping new models. Xiaomi announced SU7 with Dolby Atmos in the second quarter and they're seeing much higher demand than expected. Also, a new partner, Hyundai is shipping the Genesis initially in Korea with Dolby Atmos. We're also seeing momentum and revenue growth from existing partners, both in terms of the aggregate growth from current models and also an increase in new models, especially from partners like Mercedes, Nio and Lucid.

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So before I move on to my closing thoughts, I want to say that I'm proud of all the hard work and successes our teams are having, driving content growth, innovating on the product front. These efforts are the backbone of our business and ensure that our partners continue to value and grow their relationship with us.

Looking forward, foundational remains solid despite persistent softness in device sales. An improvement in the macro and a return to device sales growth will have a meaningful positive impact on our revenue and margins. In Dolby Atmos and Dolby Vision, ongoing progress with our content and streaming partners are creating an ever growing groundswell of support for our 3 main focus areas: TVs, mobile and automotive.

We continue to expect to deliver margin growth ahead of revenue growth. Our balance sheet is strong, and I remain confident about our long-term prospects. And so with that, I'll turn it over to Robert, who will take you through the financials in a bit more detail.

Robert J. Park - *Dolby Laboratories, Inc. - Senior VP & CFO*

Thanks, Kevin, and thanks to everyone joining us on the call today. Before we review the quarter in some detail, I'd like to hit the highlights.

First, revenues for Q2 were just above the midpoint of the range we laid out in the Q1 earnings call, and profitability also came in above the midpoint of the range. Second, while the environment remains uncertain and dynamic, our guidance for the year remains unchanged. And third, as I have said before, we feel good about our long-term growth prospects. Our value proposition remains strong and our financials are solid.

Q2 revenue was $365 million, down 3% compared to the year ago quarter, but above the mid-quarter guidance we shared with you on the last earnings call. Licensing revenue of $338 million was down 4% year-over-year. Products and services revenue was $26 million, up 8% year-over-year. Our end market outlook for the full year is unchanged from last quarter's call. Detailed licensing performance by end market is on our IR website, but I'd like to point out some noteworthy details.

As a reminder, timing of recoveries, the minimum volume commitments and true-ups can drive volatility between quarters. Mobile is the biggest standout in the quarter, growing 151% sequentially, primarily due to timing. And although we saw a nice snapback from mobile in the quarter, we still expect mobile to be down slightly for the full year.

Similarly, you may notice that broadcast is down 18% year-over-year this quarter. This, again, is just about timing. As we have said before, we expect broadcast to be down slightly for the full year. We continue to expect solid growth in auto and a slight increase in PC. This increase will be offset by slight declines in broadcast, consumer electronics, mobile and to a lesser extent, gaming. While we see growth in Dolby Atmos and Dolby Vision in these markets this year, the overall revenue declines are primarily due to tough comps in terms of the timing and size of the deals.

Moving to the bottom line. In Q2, we earned $1.27 per diluted share on a non-GAAP basis, above the midpoint of our guidance, primarily due to stronger revenue, higher nonoperating income and lower taxes and we generated $181 million in operating cash flow.

Moving on, we repurchased $25 million worth of common stock and have about $107 million remaining on our repurchase plan authorization. We declared a $0.30 dividend up 11% from our dividend a year ago and ended the quarter with cash and investments of just under $1 billion.

Turning to guidance. There is still uncertainty in the market, and our guidance assumes no material change in the macroeconomic environment. While we continue to see steady growth of content created and distributed in Dolby technology and strong engagement from our partners, device shipments remain soft and the timing of deals can vary.

For Q3 fiscal year '24, we expect revenue between $270 million and $300 million. Within that, licensing revenue is estimated to range from $245 million to $275 million. Gross margin should be approximately 87% on a non-GAAP basis. We expect non-GAAP operating expenses to be between $180 million and $190 million. Our effective tax rate for Q2 is projected to be around 21% on a non-GAAP basis. So as a result, we estimate that non-GAAP EPS should be between $0.51 and $0.66 per diluted share.

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Moving on to full year guidance. Coming into the year, we said revenue would be weighted more towards the first half of the year than the second half of the year. And midway through the year, that first half weighting is slightly more pronounced than we expected. First half revenue benefited from timing of deals that we expected in the second half of the year. For this reason, our full year guidance for fiscal year '24 is unchanged at roughly flat revenue.

In the second half, we are expecting a higher revenue weighting towards the fourth quarter due to the timing of deals. Taking a step back, our full year guidance, consistent with what we've been saying all year, reflects an assumption of a mid-single-digit decline in foundational audio licensing revenue, offset by a high single-digit growth in Dolby Atmos, Dolby Vision and imaging patent licensing revenue and roughly flat products and services revenue.

Non-GAAP gross margin should be roughly 89%. Non-GAAP operating expenses for the full year should be in the $740 million to $750 million range which will result in about a 1 to 2 percentage point improvement in operating margins on a full year basis. On the bottom line, we are expecting non-GAAP EPS of between $3.60 to $3.75.

To wrap things up, the creation and distribution of Dolby-enabled content continues to grow nicely and our partners are still very engaged. Our financials remain strong, and we are well positioned for growth when economic conditions improve. With that, I'd like to turn it back to the operator to open the line for your questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Your first question comes from the line of Steven Frankel with Rosenblatt.

Steven Bruce Frankel - *Rosenblatt Securities Inc., Research Division - Director of Research & Senior Research Analyst*

Kevin, you've made tremendous progress with content, as you outlined on the call. Given what you've heard from your partners at CES, how does that position you in terms of Atmos and Vision penetration in the 4K TV market when we get to holiday 2024 versus last year?

Kevin J. Yeaman - *Dolby Laboratories, Inc. - President, CEO & Director*

Yes. Thanks, Steve. Well, as we've said and as I think as you are pointing out, we do think sports is a really compelling use case that can really be a strong value proposition for driving adoption deeper into these lineups. And we're still seeing some carry-through of increased sales of Atmos and Vision TVs from some of the announcements we've made over the last year. Those things take a while to roll through the pipeline as older models stay in market and we've added quite a few regional providers over the last year.

So we're very excited about that we're really beginning to see -- hit a new stride as it relates to sports content, and our partners see value in that. So we very much believe in the opportunity to expand the presence of Dolby Atmos and Dolby Vision on TVs and around living room devices. This quarter very recently, VIZIO has begun shipping Dolby Atmos sound bars at $99. So that's -- so we're -- we think that we're doing a lot to reach the mainstream consumer.

Steven Bruce Frankel - *Rosenblatt Securities Inc., Research Division - Director of Research & Senior Research Analyst*

Great. And then the capital allocation question, pretty striking to me, given your cash generation capabilities, the cash on the balance sheet that the buyback pace was half of what it was a year ago. And now after several quarters of the share count kind of being flat, share count is growing again. Why not -- and the stock is kind of where it has been. So why not be more aggressive on the buyback?

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Kevin J. Yeaman - *Dolby Laboratories, Inc. - President, CEO & Director*

Yes. So well, first of all, I would say, as you know, we're committed to a minimum, offsetting any dilution from stock-based compensation. And so all else held equal, then we'll be looking to keep the share count flat. So if it's increasing quarter-to-quarter, that has to do with the timing and nuance of trying to get it just right.

But also to your point, we have on occasion in the past done more, and we continue to evaluate that on a quarter-by-quarter basis. We've returned about $4 billion over the last 10 years, and so we do watch it closely and continue to evaluate it on a regular basis.

Steven Bruce Frankel - *Rosenblatt Securities Inc., Research Division - Director of Research & Senior Research Analyst*

Okay. And then what were true-up in the quarter?

Robert J. Park - *Dolby Laboratories, Inc. - Senior VP & CFO*

Steve, true-up in the quarter was negative $6 million, primarily in broadcast, consumer tectonics and gaming consoles offset by higher units of auto shipping with Dolby Atmos.

Operator

Our next question comes from the line of Ralph Schackart with William Blair.

Ralph Edward Schackart - *William Blair & Company L.L.C., Research Division - Partner & Technology Analyst*

Kevin, it sounds like you have some good upbeat updates on Atmos and within the auto segment. Maybe just if you can give a little bit more color and kind of compare and contrast some of the activity in that space this quarter versus last with either conversations with potential future OEMs or maybe some perspective going forward about how that technology make its way to more mass market vehicles quicker, perhaps versus other technologies that you've seen in autos historically? Then I have a follow-up.

Kevin J. Yeaman - *Dolby Laboratories, Inc. - President, CEO & Director*

Yes. Thanks for that, Ralph. We continue to be really excited about the momentum we have in music and in automotive. As I said on the call, we had Xiaomi launched its car with Dolby Atmos. It's had really strong demand. Hyundai began shipping Genesis in Korea. I also noted that we're seeing a higher aggregate volume of sales for the models that have been put into the market. I think I saw on the news this morning that Nio had a really good shipment quarter. And we're seeing more models from our current partners, specially Mercedes, Nio, Li Auto.

So all of that is going really well. And the pipeline is robust. We have really good engagement across the automotive industry. And they are -- to the last part of your question, as you would expect, everybody is starting with their highest end models as it relates to the Dolby Atmos experience. But we believe and we believe that the music industry believes this is the way to experience music that we're going from stereo to a new, more immersive way to experience music, which is what gives us confidence that this will have mass market appeal.

We want to get on every car. And you'll remember that at CES, we were demoing a 4-channel solution for a car, which is consistent with the cost footprint of mass market, and that was well received. So the pipeline is strong, and we continue to be really pleased about the progress we're making.

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Ralph Edward Schackart - *William Blair & Company L.L.C., Research Division - Partner & Technology Analyst*

Great. And then just in terms of Dolby IO, I think historically, you've framed the opportunity and I'm not sure if the incremental use cases of low latency were sort of additive to that previous size. So maybe if you could just take a step back and sort of reframe the opportunity or remind me of that opportunity. That would be great.

Kevin J. Yeaman - *Dolby Laboratories, Inc. - President, CEO & Director*

Yes. Thanks for that. So as you know, the majority of our revenue today comes from building ecosystems around content, distribution, device where our monetization comes from the device. And this is an opportunity to improve audiovisual experiences by working with service providers who are looking to bring real-time digital experiences that are more interactive, more personalized, really with the goal of increasing fan engagement.

And you might remember that we had a shift in our approach coming into this fiscal year. We had a self-service model where we had -- we were working with hundreds of developers who are using a range of our capabilities. And where we saw demand where companies wanting to build these digital experiences at larger scale. And with particular immediate -- in the immediate term, you mentioned the ultra low-latency streaming, meaning hundreds of milliseconds.

So you -- what that means experientially is that there's hardly any perceptual difference, you may not detect the difference between what streaming on the phone and watching something live, which opens up a lot of use cases. And so we said last quarter, we were pleased to have closed our first couple of 7-figure deals. This quarter, we had a number of 6-figure deals, which we believe we can grow into 7-figure deals. The pipeline is growing.

We have -- in the most immediate term, we see a higher concentration in things like iGaming and sports betting, where the ultra low latency is a really strong use case. But in the pipeline, we're beginning to see the types of use cases diversify into more broad applications that are targeted at increasing engagement with audiences and fans.

Operator

Next question comes from the line of Jim Goss with Barrington Research.

James Charles Goss - *Barrington Research Associates, Inc., Research Division - MD*

A couple of things. First, on televisions. Are you getting beyond that COVID bump in sales that might give you a chance to have maybe an acceleration in the TV sales that might help your service? And is there a possibility of getting some idea of the current Atmos penetration in broadcast as well as mobile?

Kevin J. Yeaman - *Dolby Laboratories, Inc. - President, CEO & Director*

Yes. Thanks, Jim. So to your first question, I think what we're hearing and when I look at the earnings reports of our -- some of our large customers in that space, I think they're reporting that they view things as having stabilized. They're getting a little cautious optimism around parts of their business. Obviously still caution around the overall economy. So as I said, we're confident that device sales will return to growth.

But as Robert said, we're not baking that into our guidance for the rest of this year. As it relates to Atmos, we have a strong adoption at the high end of TVs. We are increasing penetration at the small to mid-tier really just about Mir's Dolby Vision in that respect. And beyond that, a lot of excitement around speaker related devices. I mentioned earlier, VIZIO now coming to market with a $99 Dolby Atmos sound bar.

In mobile, we have very good adoption of Dolby Atmos across Apple, of course, Samsung, we've been increasing our presence with Dolby Vision and Dolby Atmos with the high-end models of most Chinese phone manufacturers. And if you didn't catch it, one thing I said on the call is that as

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it relates to Dolby Atmos, Transsion, which is a Chinese company, and I understand most of their business is in Africa and then also Lava Mobile in India, both adopted Dolby Atmos. So that gives us some more traction at more affordable entry points.

James Charles Goss - *Barrington Research Associates, Inc., Research Division - MD*

Okay. And you had mentioned automotive or well, Atmos in automobiles with Xiaomi and Genesis. Are you -- of the opinion that rollout -- that acceleration of that rollout could be fairly quick? Or do you think it will take a number of years to really gain traction and move into those less expensive autos, as you mentioned, it was sports channel device.

Kevin J. Yeaman - *Dolby Laboratories, Inc. - President, CEO & Director*

I think I want to say both in the sense that we're seeing high growth rates now of smaller numbers, and we expect that to continue and that it's going to continue to build. And I think every partner differs in terms of their strategy of how fast they're going to bring it to models. Mercedes has brought it to -- continues to roll out new models on a regular basis and how quickly, therefore we get to that mid-end.

I think what's consistent is that any time we get a new partner, they're going to want to start with their high end. I think that's going to probably be pretty consistent. But we're really pleased with the engagement, the trajectory and the rollout so far.

James Charles Goss - *Barrington Research Associates, Inc., Research Division - MD*

Okay. Last thing. Gross margin on products and services was down and lower than I think I would have expected. Is there -- or what would be the reasoning behind that? And what should we expect over the next couple of quarters?

Robert J. Park - *Dolby Laboratories, Inc. - Senior VP & CFO*

Yes. The product and services gross margin can vary based on inventory reserves we take in any given quarter. But for the full year, we expect it to be a more normalized basis for our products and services gross margin, but it can vary quarter-to-quarter.

Operator

Ladies and gentlemen, that concludes today's call. Thank you all for joining. You may now disconnect.

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