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Q3 2024 DOLBY LABORATORIES INC EARNINGS CALL

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CORPORATE PARTICIPANTS

- **Peter Goldmacher** *Dolby Laboratories Inc - Vice President, Investor Relations*
- **Kevin Yeaman** *Dolby Laboratories Inc - President, Chief Executive Officer, Director*
- **Robert Park** *Dolby Laboratories Inc - Chief Financial Officer, Senior Vice President*

CONFERENCE CALL PARTICIPANTS

- **Operator**
- **Ralph Schackart** *William Blair & Company - Analyst*
- **Jim Goss** *Barrington Research Associates - Analyst*

PRESENTATION

Operator

(audio in progress) (Operator Instructions) As a reminder, this call is being recorded Wednesday, August 7, 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 *Dolby Laboratories Inc - Vice President, Investor Relations*

Thank you, operator, and good afternoon, everyone. Welcome to Dolby Laboratories third quarter 2024 earnings conference call.

Joining me today are Kevin Yeaman, Dolby Laboratories' CEO, and Robert Park, our CFO.

As a reminder, today's discussion will include forward-looking statements, including our fiscal 2024 fourth 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 risks 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 Yeaman *Dolby Laboratories Inc - President, Chief Executive Officer, Director*

Thank you, Peter. And thanks to everyone joining us on the call today.

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Revenue for the quarter came in just above the midpoint of the range that we provided you on the last earnings call and earnings were above the high end of the range. For the full year, we now expect revenue to be down approximately 1% to 2%, which is at the lower end of what we've been expecting throughout the year. We are not making any changes to our non-GAAP EPS guidance for the year.

Our foundational audio revenue is coming in lower than we expected as global device sales in aggregate have been soft all year, and we are seeing lower than expected units in set-top boxes and gaming consoles for the second half of the year.

In products and services, cinema products are coming in lower than we expected as the box office remains sluggish and exhibitors continue to push out CapEx. Dolby Atmos and Dolby Vision are performing slightly ahead of our expectations as strong content growth continues to drive device attach rates. Dynamics remain stable and ongoing engagement from the broader ecosystem of creators, distributors, and device manufacturers are driving a steady stream of product launches across all device families. We continue to be confident in our growth opportunity with Dolby Atmos and Dolby Vision, and we have a strong position with our foundational audio technologies, which are well positioned as our end markets return to more normal cycles.

Moving onto the highlights for the quarter. We continue to enjoy momentum in content for Dolby Atmos and Dolby Vision, which is driving growth in autos, TVs, and mobile; our three biggest areas of opportunity. Starting with content, I'm happy to share that as of this spring, over 25,000 TV shows and movies have been made available in Dolby Vision, a significant milestone considering that we launched Dolby Vision in October of 2015, with just 13 movies from one studio and one TV OEM. Since that initial launch, Dolby has worked across the ecosystem on a global basis to add studios, production companies, product partners, content service providers, and device partners to the Dolby Vision story. And we are taking that Dolby Vision momentum and TV and movies into live sports.

Comcast Xfinity in the US and a variety of global partners are making the Olympics available in Dolby Atmos and Dolby Vision, which builds on the momentum we've seen throughout this year. In Q3 alone, the Cricket World Cup, European Championship soccer, Wimbledon, the NHL, and NBA postseason were all available in Dolby Atmos and Dolby Vision. And of course, we aren't stopping there.

In May, Tencent Music cited Dolby Atmos music on their earnings call mentioning that we help them to drive 20% year-over-year growth by making their music offerings more attractive and stickier, which is something we love to hear. And Audible recently announced that they will continue to expand their library of Dolby Atmos content with full cast audio productions of all seven Harry Potter books scheduled to premiere in late 2025.

Moving on to automotive, GM announced this quarter that the 2025 Cadillac OPTIQ will feature Dolby Atmos, our first car with GM. And also this quarter, Rivian announced that the second generation of its flagship vehicle, the R1, will support Dolby Atmos. And Hyundai announced that its luxury brand, Genesis, will make Dolby Atmos standard across five models starting in Korea. We now have 20 OEM partners for Dolby Atmos and the momentum continues to build.

In TVs, we are seeing a slight uptick in attach rates. Hisense and TCL, which are both strong adopters of Dolby Atmos and Dolby Vision, continue to gain market share, and we continue to get incremental wins as other TV OEMs look to bring Dolby Atmos and Dolby Vision deeper into their lineups in order to compete more aggressively in certain markets. Also contributing to the momentum are additional drivers like the growth in sports content that we just covered.

Lastly, in mobile, in addition to the steady rollout of new models from most of our mobile OEM partners, Transsion, added a Dolby-enabled low-cost phone to consumers in Malaysia, as the company continues to sell affordably priced higher-end phones aggressively into Africa, the Middle East, India, and Southeast Asia.

Moving on to M&A, I'd like to briefly discuss our pending acquisition of GE licensing, which complements strengthens and expands Dolby's patent offerings, particularly in imaging and represents a compelling financial profile of durable, reoccurring, high-margin revenue. This transaction adds a significant portfolio of video codec technologies that provide best-in-class video compression while also enabling better overall picture quality and higher resolution, which is particularly important in applications like streaming and video conferencing.

In addition to strengthening our current video patent licensing programs, this acquisition continues to position us well for new licensing opportunities. These patents are primarily monetized through patent pools, which are collaborative licensing structures that enable industry efficiency and promote long-term growth by facilitating the adoption of next-generation standardized technologies. We expect the transaction to close by the end of the fiscal year and expect it to be accretive on a non-GAAP basis to operating margins and EPS in fiscal 2025.

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Also on M&A, we recently enhanced our Dolby.io offering with the acquisition of video THEO Technologies for $55 million. As we've talked about, we are seeing demand from companies in sports and entertainment who are looking to create real-time and personalized experiences. THEO addresses a similar customer base with complementary technologies. This acquisition gives us more momentum from both a product and customer perspective and a stronger foundation to build on. Neither of these deals will have a material impact on FY24.

In summary, we continue to operate in an uncertain and dynamic market environment with lower unit shipments and cinema box office weighing on revenues this year, particularly in foundational. At the same time, we continue to grow our Dolby Atmos and Dolby Vision content ecosystems across movie, TV, sports, and music and to grow device adoption particularly in automotive, TV, and mobile. We remain committed to growing earnings faster than revenue while investing in a healthy portfolio of innovation, and we are strengthening our imaging offerings with a financially attractive acquisition. I continue to be very excited about the opportunities in front of us and the opportunity to deliver revenue and earnings growth.

And with that, I'll turn the call over to Robert.

Robert Park *Dolby Laboratories Inc - Chief Financial Officer, Senior Vice President*

Thanks, Kevin, and thanks to everyone joining us on this call today.

Before we review the quarter at some detail, I'd like to hit the highlights. First, revenues for Q3 were above the midpoint of the range we laid out on the Q2 earnings call and profitability came in above the high end of the range.

Second, the environment remains uncertain and dynamic. Our revenue guidance for the full year is skewing towards the lower end of what we've been describing as roughly flat all year. And our non-GAAP EPS range is unchanged.

And third, as I said before, we feel good about our long-term growth prospects and our value proposition remains strong and our financials are solid.

Q2 revenue was $289 million, down 3% compared to the year-ago quarter, but above the midpoint of guidance we shared with you on the last earnings call. Licensing revenue of $267 million was down 2% year over year. Products and services revenue was $22 million, down 14% year over year.

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, minimum volume commitments, and true-ups can drive volatility between quarters. For example, mobile, which benefited from minimum volume commitments this quarter, was up 25% year over year, but will still be down slightly for the full year.

Similarly, consumer electronics revenue was down 18% year over year in the quarter, but we expect revenue to be down slightly for the full year. We expect broadcast revenue to be down year over year for the full year, driven by tough comps in terms of timing and size of deals and lower set-top box revenue.

On the flip side, we continue to expect solid growth in other markets driven by imaging, patent, admin fees, and increased adoption of Dolby Atmos and auto. PC is benefiting from minimum volume commitments and slightly higher unit volumes.

Moving to the bottom line. We earned $0.71 per diluted share on a non-GAAP basis above the high end of our guidance, primarily due to strong revenue, lower operating expenses, and higher nonoperating income and we generated $21 million in operating cash flow. As a reminder, cash flow will fluctuate quarter to quarter due to timing of deals, but over time, operating cash flow will correlate to non-GAAP net income.

GAAP operating expenses included a restructuring charge of approximately $4 million for severance and related benefits as we continue to align resources with our strategic priorities. Moving on, we repurchased $35 million of common stock and we have $72 million remaining on our repurchase plan authorization. We recently received Board approval to increase the existing share repurchase authorization by $350 million, bringing our total authorization to about $420 million. 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. It continues to be an uncertain and dynamic market. Device shipments remain soft and the box office remains sluggish, which has had negative implications for both our licensing and product and services revenue. At the same time, we continued to see steady growth of content created and distributed in Dolby technology, strong engagement from our partners and revenue from Dolby Atmos and Dolby Vision and imaging patents is performing a bit better than expected.

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For Q4 fiscal 24, we expect revenue to be between $300 million and $320 million. Within that, licensing revenue is estimated to range from $275 million to $295 million. Gross margins should be approximately 88% on a non-GAAP basis. We expect non-GAAP operating expenses to be between $190 million and $200 million.

Our effective tax rate for Q2 is projected to be around 23% on a non-GAAP basis. So as a result, we estimate that non-GAAP EPS should be between $0.61 and $0.76 per diluted share. This Q4 guidance implies full year revenue between $1,270 million and $1,290 million at the lower end of what we've been describing as roughly flat revenue all year as we are seeing lower than expected unit shipments and lower revenue from cinema. However, we still expect non-GAAP earnings to be within the range we've been discussing all year of $3.60 and $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 solid, 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)

Ralph Schackart, William Blair.

Ralph Schackart *William Blair & Company - Analyst*

Kevin, just on the macros to kick it off. Just curious what you observed in this quarter in relation to what you observed last quarter. Was it sort of within bounds maybe at the lower end given sort of the slight tweak to guidance, but anything you could add of the macro that have held?

Kevin Yeaman *Dolby Laboratories Inc - President, Chief Executive Officer, Director*

Yeah, of course. Thanks, Ralph.

Yeah, I guess I would say that as far as the macro goes, we're seeing much the same we've been seeing all year. I think that it's fair to say it's been a tough environment for our OEM customers over the last several years, but we see them, I think, cautiously optimistic that things are stabilizing, looking for opportunities for growth, and we continue to have really strong engagement on content distribution devices for Dolby Atmos and Dolby Vision.

What we did see this quarter, Ralph, that was a little more specific is we, as I mentioned, some softness in set-top boxes and gaming consoles. So it's really just set-top boxes are the industry analysts and our customers and partners were expecting set-top boxes to begin to tick up through the year. That worked through a pretty big inventory level last year, and we're not seeing that. We're seeing it stay kind of flattish. And so we had a negative true-up in Q3 of $8 million, which was in the set-top box the biggest part, also continued weakness in gaming consoles, and we see that continuing through the year.

At the same time, there's always puts and takes in the quarter. So we had a few things come in early in Q3, which is why you didn't see it show up relative to our guidance for Q3. So and then I would say on top of that, the box office continued to be pretty soft through the end of Q3. So we continue to see the pushing out of cinema product purchases. So I would say those two specific things were what contributed to the slight adjustment, but I wouldn't characterize it as a big macro change.

Ralph Schackart *William Blair & Company - Analyst*

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Okay. That's really helpful, Kevin.

And just one more just on the new patents that you acquired from GE, curious if you could leverage these patents either into existing products or potential for future products. I know some part of that they had applied a video compression. So overall, curious perhaps could this help your Dolby.io efforts as well?

Kevin Yeaman *Dolby Laboratories Inc - President, Chief Executive Officer, Director*

This is really -- so first of all, we're always looking for opportunities that can expand or accelerate our existing business initiatives. And this is very much focused on our imaging patent business where we license our -- through patent pools, which are collaborative licensing structures. And this is really this -- for us this is a pretty unique opportunity in terms of the ability to bring on a very attractive portfolio -- patent portfolio in the -- particular in the video codec technology space. So it expands our presence in imaging patents. It's a very attractive and durable set of revenue streams and we expect it to be accretive to both nonoperating or -- non-GAAP operating income and EPS in the first year.

We also did -- as it relates to IO, we did also this quarter, acquire a startup by the name of THEO Technologies, which we -- which does enhance the Adobe.io offering. As you know, we're very much focused on sports and entertainment companies that are looking to offer real-time more interactive digital experiences. We really refocused our efforts around that coming into the beginning of this fiscal year.

THEO has a video player and features and functions that increase interactivity. They serve a very similar customer base. And so it's -- on the one hand, it's a buy-versus-build because it's a very complementary set of technologies, allows us to provide a more complete solution. And we also think it can increase sales momentum because the ability to cross-sell in fact, we have a number of customer prospects in common and we're getting very positive feedback and so we're excited about that one as well.

Operator

Jim Goss, Barrington Research.

Jim Goss *Barrington Research Associates - Analyst*

First, I'd like to ask about Atmos in cars. You gave a number of them and usage points, including Cadillac OPTIQ, Rivian, Genesis. In the Genesis, with five different models being used, that's pretty rare, I think, to this point. But I'm wondering if you're seeing that in a number of the other applications. How -- do you feel you are picking up momentum and broadening the usage within cars?

Kevin Yeaman *Dolby Laboratories Inc - President, Chief Executive Officer, Director*

Yeah. Thanks, Jim. Very excited to have Cadillac on board with the first model. And also you would have seen that we added Rivian. Hyundai is now offering five models in Korea. And we continue to see that -- we have 20 OEM partners and we continue to see many of them expanding into additional models and get deeper into lineups. And so this is an area where in Dolby Atmos and Dolby Vision for -- Dolby Atmos for automotive, we're doing better than we expected coming into the year. And it's a function of going deeper into lineups, continuing to bring on new models and some of those doing just exceeding their unit projections.

Jim Goss *Barrington Research Associates - Analyst*

Okay, and the way you're monetizing this is -- payment for, it's not a royalty base, but it's more of an installation base in the products area. Is that correct?

Kevin Yeaman *Dolby Laboratories Inc - President, Chief Executive Officer, Director*

It's our typical model. We get them out for each car.

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Jim Goss *Barrington Research Associates - Analyst*

Okay.

And the movie business is at a low point, obviously, but it's been starting to recover and expectations are pretty high for '25 and '26. I'm wondering if that's -- [prouding] you to increase the number of theater installations, either domestically or internationally, or both?

And just -- I mean, any comments you might have on that. That also the real monetization has been the TV applications, other consumer products. And I wonder if you might also elaborate and just how that penetration continues to go and whether you're getting similar royalties as you move to expanded lower prices are used?

Kevin Yeaman *Dolby Laboratories Inc - President, Chief Executive Officer, Director*

Yeah, I think, Jim. So of course, as you know, we came into the year expecting that box office this year would be affected by the lingering effects of the strikes and the scheduling and the release schedule. And if anything through the end of June, that was probably a little softer than most expected.

But at the same time, we and the industry are optimistic about '25 and '26 because a lot of those titles are -- there's a lot of great titles that will be ready to come out. And it's nice to see this quarter, the September quarter off to a really strong start.

So to answer your question, even as we've seen people pushing product sales later into the year or into next year, we're seeing increased engagement as it relates to Dolby Cinema and also the ability that we announced at CinemaCon to incorporate Dolby Vision and Dolby Atmos into existing exhibitor branded DLFs.

And that's because even throughout this period of time, beginning with the pandemic and it's continued to be strong, the percentage of the box office that is going to premium large-format experiences, including Dolby Cinema, is significantly increased as a percentage of the box office. So exhibitors see that and we have increased engagement as they look to increase their premium experience footprint as they -- and with optimism as they look at the potential for box office in '25 and '26.

Jim Goss *Barrington Research Associates - Analyst*

Within the United States so, it's your contract is still an exclusive of AMC, I believe, with the full vision, Atlas package. So are you and I don't think that's changing. Are you finding out a number of other areas around the world where you are increasing that penetration and hoping to do the same in terms of spring, device shipments in those other markets as well?

Kevin Yeaman *Dolby Laboratories Inc - President, Chief Executive Officer, Director*

Yeah, you said device shipments, are we still on Dolby. Did you mean (multiple speakers)--

Jim Goss *Barrington Research Associates - Analyst*

Dolby Cinema.

Kevin Yeaman *Dolby Laboratories Inc - President, Chief Executive Officer, Director*

Okay. So yeah, today, AMC is our partner in the US and there are well over 150 screens. So it's a great partner with us. We also have a number of partners in Japan, in Europe, in Korea where Megabox recently announced that they would expand with us. So we have a pretty good footprint across the globe and demand around the globe. So I think as we go into next year, and it's -- like you said, it's a positive sign that Q4 is off to a good start, we're optimistic that we can begin to increase the number of Dolby Cinema and Dolby Atmos, Dolby Vision installations.

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Operator

We have no further questions at this time. With that, we will conclude today's conference call. Thank you all for your participation. You may now disconnect.

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