Corning: Morgan Stanley Technology, Media & Telecom Conference

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Meta Marshall: Welcome, everybody. I'm Meta Marshall. I cover the networking space here at Morgan Stanley. We're delighted to have Corning here today. Edward Schlesinger, I know I just butchered that, CFO, but I gave it my best shot. For important disclosures, please see the Morgan Stanley Research Disclosure website at Morganstanley/research disclosures. If you have any questions, please reach out to your Morgan Stanley sales representative. And if you want to introduce yourself in a more appropriate fashion, that'd be great. But Corning -- maybe let's just kick off. Corning saw recessionary demand across most of your portfolio for much of 2023. You noted on the Q4 call that Q1 should mark a bottom. Just what are signposts you're watching for in the various segments for when demand could return?

Edward Schlesinger: Thanks, Meta, it's great to be here. Thanks for having Corning. Yeah, as you mentioned, we're definitely seeing a depressed demand across most of our markets. We've described it as the markets and our businesses being below their long term trendlines. The causality of that is a little bit different in each of the businesses, but some common things. And we're looking for those as the signposts for things to return.

For example, in our optical communications business, customers bought too much, so we're looking for them to digest that excess inventory. As we kind of go through the year, we're expecting that to happen at some point, maybe even middle of 2024. Again, sticking with optical, we're looking at the rate of deployments in the carrier space where we constantly are in discussions with our customers. If they deplete their inventory, that will increase our sales even if they don't increase their deployments. But we're expecting deployments to increase through the year to some extent.

And in the hyperscale space, we're looking at the increase in capacity for AI models. In display, panel maker utilization, we look at the rate of utilization of panel makers and that level is depressed. It was depressed in the fourth quarter. In the first quarter, we're expecting that to increase. That will be a signpost for us. So those are the sorts of things that we watch. And again, we're expecting all of our markets to return back to those trendlines over time.

Meta Marshall: Okay. Understanding we're earlier in the year and you just kind of described a little bit of the segments, but just kind of contextualizing, where should we expect demand to return earlier versus later? And just what are some of those signposts that you're looking at?

Edward Schlesinger: I think display is a good place to start. Panel makers took utilization down in the fourth quarter. Retail demand was a little weaker. They are running that utilization lower in the first quarter. You have Lunar New Year which always impacts the first quarter to some extent. If we think about where they're running today, they could not meet demand for the year. We have to see them increase utilization as we exit the first quarter. I think that's a place where probably earlier in the year we'll see some sort of recovery. The magnitude of that is always hard to tell, but certainly higher than first quarter levels.

I think life sciences is a place where inventory is depleting in North America and in Europe, so again, starting to see some signs there. Hyperscale is a place where we're starting to see our orders increase a little bit, so those are places that might come back a little earlier. In the carrier space and optical, I think that's probably more of a second half impact than in first half.

Meta Marshall: Okay, perfect. Given the weak demand, you guys have taken a number of kind of initiatives on the cost structure. But just what kind of improvements could we see to margins as demand recovers? And if you want to outline some of those initiatives that you've taken.

Edward Schlesinger: Thanks. During 2023, it was really important for us to improve profitability and cash flow. We had entered the year at a lower point. Some of the drags from the pandemic-related supply chain impacts. We did a lot of things. We increased the price through the year. We improved the productivity. We describe that as sort of our productivity ratios or metrics. We got that back to historical levels. As we exited the year, our gross margin was about 300 basis points higher than when we started the year 2023. And of course, that impacts our cash flow as well. We regulated operating expense and capital expense and all of that contributed to nice cash flow improvements as well as we went through the year.

Our goal is to sustain that level of performance and as volume begins to come back, that should be accretive to our margins. And we have a leverage point on the gross margin level and a leverage point on the operating margin level because we expect to be able to operate with the level of costs we have today as we start to see our sales come back.

Meta Marshall: That's helpful. With the pullback in fiber demand over the past year, you've given some helpful exhibits just how far off we are from the trendline. Nealy 30% in the second half of 2023. When you talk to service provider customers, does this echo with what they think the long-term trajectory of demand is past the inventory digestion? And just you mentioned maybe we start to see a resumption in the second half, but just kind of what are your conversations there as to what the trendline and demand will be?

Edward Schlesinger: Yeah, I would say nothing makes us feel like the trendline won't continue on in the optical space relative to historical performance. Sort of all the underlying drivers of growth, the buildout of broadband, for example the rural broadband rollout in the United States, the continued need for cloud computing, AI, all of those things will continue to drive the need for optical connectivity and optical networks. We think the trendline itself makes sense. And when we talk to our customers and we look at the levels they're deploying at, the levels we'd expect them to deploy at going forward, we also think that that generally makes sense.

If you think about history, there are things that go above that trendline and things that are below that trendline, and that averages out to sort of that historical level. I would expect some things, some drivers like for example the hyperscale AI buildout, to go above that trendline. But on average for us to continue to get back there. And as we've stated, we are about 30% below that trendline which actually is about a 40% increase from our current level of sales when we get back to that trendline.

Meta Marshall: Okay. As you're thinking around the second half of the year for when service provider demand could return, how much of that is influenced by BEAD fund and when you think that BEAD will impact demand versus just inventory digestion and where we are there?

Edward Schlesinger: Yeah, I think for 2024 it's about inventory digestion in the carrier space. And as that comes to a conclusion, that will increase sales for Corning for people, for customers to start buying again to meet their current deployment level. BEAD probably starts to impact us late in the year. Certainly, more of a 2025 impact than 2024. I think as you know, states have to meet certain criteria to be able to apply and then they have to get approved and then the funds have to start flowing and they have to design out their network and select their providers and all of that kind of stuff. And that just takes time before we'll see it in our order books.

Meta Marshall: I know you've contextualized this in the past, but just to restate kind of what you think that that impact of BEAD could be just to kind of overall fiber demand.

Edward Schlesinger: I think if it actually gets up and running, when it's fully ramped up, it could be one of those things that goes above the trendline. That's a good way to think about it. But we'll be cautious, we're cautiously optimistic about how it impacts us. And I think for sure as the year progresses, we'll know more about who wins what aspect of that and how it impacts us.

Meta Marshall: Perfect. Moving onto display, in your 2024 outlook you mentioned expectations for the panel maker utilization declines in Q1. Some recent commentary of the industry suggests that the panel makers might not see as big of a decline in Q1 as you originally thought. You mentioned display might come back a little bit sooner. How are you reading some of the early signs on panel maker utilization in terms of what it could mean for your demand?

Edward Schlesinger: I would say for us it's playing out more or less like we thought when we did our earnings call back at the end of January. Nothing really materially different from that. Q1 levels certainly well below where they need to be and our expectation is that that increases as we go through the year.

Meta Marshall: Got it. You've been able to pass through some significant price increases through the display business recently in part just given continued weakening. Can you just explain what you you're trying to solve for and why it's had more of a margin impact versus a revenue impact?

Edward Schlesinger: Yeah. The most important thing for us is to generate a return in this business that's sufficient for the invested capital we have. The return on invested capital in the business to sort of meet a threshold. That's our main objective. We've been doing that by protecting ourselves against the yen, by having the lowest cost, by being the technology leader, and most recently in 2023 by raising price. As I think about going forward, our goal will be to kind of maintain that level of profitability. A way to think about it would be to take our net income as a percentage of sales. If that's in a greater than 25% range, 25% to 30% range, that's a good place for us to be. If you think about that kind of on an annualized basis, I mean volume always in any given quarter could have an impact on how that plays out. That's our main objective. When we think about that going forward, obviously price will be an important component of that given where the yen is at.

Meta Marshall: Okay. But just in terms of kind of why we don't see it in revenue, but we do see it on margins, just makes it a mindbender sometimes for investors.

Edward Schlesinger: Yeah, I think we have many mechanisms to raise price if you will. Some of those impact the revenue line and some of those don't. We use all of those tools and I think that's why you're not necessarily seeing the same impact on the revenue line as you might see on the profitability line.

Meta Marshall: Okay. Then a secondary question we get is just have you seen any impact to share as a result of this price increase?

Edward Schlesinger: Yeah. I mean we remain the market leader in this space and we certainly would potentially be willing to trade share for the right level of profitability. But so far, so good. Not very much impact.

Meta Marshall: Okay. The majority of your yen hedges roll off at the end of the year. You noted that further price increases are a way to kind of protect that income ratio that you were speaking about. Just how are you judging the ability to push price to the panel makers versus kind of share position in that space?

Edward Schlesinger: A couple of thoughts. Maybe just starting with the yen, obviously the yen is in a place where we don't think it makes sense to be a long-term hedger at this level. But, as a reminder, we have the ability to take advantage of the forward curve. The yen, if you go out a year, is about 7 yen more favorable than where the spot rate is and then it kind of -- it's not linear, but it's sort of roughly 7 yen a year as you go out. We can go out multiple years and average the rate down to a lower place than where the spot rate is. And we'll take advantage of that. We've been hedging the yen for well over a decade and have a lot of experience there. And we expect to continue to do that, so that will be component of how we protect our profitability in this business.

We raised price significantly in 2023 and some combination of using the forward curve of the yen and raising price again will us protect our profitability as we go through 2024.

Meta Marshall: Got it. I think there was some helpful contextualization that you guys had maybe on the last earnings call or a call before just about the impact of if you raised the price of glass, what impact that actually has to overall TV price. Can you just restate that?

Edward Schlesinger: Yeah, it's not a significant component in terms of cost of an average TV. You can think about as like a 10% or some impact of the cost of a TV. Less than 10%, sorry, of the cost of a TV. So yes, for sure that has an impact in the supply chain, but it's not as significant as you might think.

Meta Marshall: Perfect. There's been some commentary of late about certain panel makers exiting the LCD business, most notably LG Display. Are any of these moves concerning to you from a customer or share position and how you think about the long-term demand for display?

Edward Schlesinger: Yeah, I think for us, that's not really new news. Most of the panel making is actually in China today. We're well positioned with the current panel makers. We've got 3 out of 4, potentially 5 facilities that exist and we think the combination of our market position and relationship with our customers really won't have an impact. We don't see that dynamic, the sort of customer dynamic changing relative to how we thought about it.

Meta Marshall: Okay. And then has there been any change into how you guys see or participate in the OLED market?

Edward Schlesinger: Yeah. I would say also no. OLED remains a relatively low percentage of the market for large size displays. It's a larger percentage of the market for some small size displays. We participate in that market today and have done exceptionally well. And we'll continue to look at technology advances in the display market and as OLED progresses, we certainly will participate in that. But we don't see it as having meaningful impact in the near term at all.

Meta Marshall: Okay, but you're not seeing -- obviously in the past, there's been concerns about that would bring less overall glass content. I think you guys have tended to see the same glass content even as you've moved into OLED.

Edward Schlesinger: Yeah, I would say depending on how the technology plays out, it could be a favorable thing for us, it could be neutral. I don't see it as having a meaningful impact. Certainly not in the near or midterm.

Meta Marshall: And then you've long called out kind of Corning's $100 a car TAM opportunity. And you also noted having won around $1 billion in multiyear auto glass orders. How should investors think about the opportunity in auto glass and just any near-term impacts on these wins?

Edward Schlesinger: I think the way to think about the auto market for us is there are trends in the market that are very favorable for both our filters, ceramics filters environmental business as well as the glass business. If I start with sort of the filter side, clean emissions is a huge move whether it's EV or filtration. We've seen a move for ICE vehicles in Europe and in China to add a gas particular filter. We're going to see that in the U.S. in the 2026 timeframe, so that's really favorable. That takes us from roughly $15 a car opportunity to more like a $45 a car opportunity. It's like a 3 or 4:1 relative to not having GPF on a vehicle. And as a reminder, a hybrid actually uses those filters as well, so a section of the EV market is a plugin hybrid or hybrid vehicles and that's actually still very favorable for our environmental business.

Then the other 2 trends that are helping us on the glass side are connectivity of the car or how the consumer interacts with the vehicle. And that's adding a number of displays or large size displays into the vehicle. And we've had a number of wins there on the glass side on the interior side, as well as autonomy which requires sensors or cameras or other technology where specialized glass is really important. Even if you think about your windshield acting like a camera lens so to speak. It just creates opportunity on the exterior glass side as well as covers for lenses or other things. And we're starting to see that as well and starting to have some wins there. I think that the interior side is probably a $30 to $40 opportunity. Exterior is $30 to $40 opportunity. And then the filters are $40, $30 opportunity. And that's how you get to that $100. And we actually have cars on the road toady that have more than $100 of our content in them, both on the EV side and on the ICE side.

Meta Marshall: Just in terms of the $1 billion of glass orders that you have announced, just in terms of how to think about the timing of some of that?

Edward Schlesinger: Yeah, we're starting to see sales ramp. It definitely takes a while as the model years play out. The business is becoming a meaningful part of Corning's sales. I think as it gets bigger and bigger, we'll share a little bit more and more about how we see that playing out in the near future. At this point, as a reminder, we include that business in our Hemlock and emerging growth business segments and it's not part of our environmental business, the auto glass business.

Meta Marshall: Got it. You just noted kind of some of the differences between ICE and EV vehicles and even kind of the opportunities that exist with hybrid. We've seen, it's been commented on at this conference in multiple sessions about the drop off in EV demand. Is there just any near-term impacts to be mindful of, of just as these kind of switches we're seeing between EVs and ICE in the near-term?

Edward Schlesinger: I would say probably not a meaningful impact for us in the near term. Obviously, the number of cars being produced is important whether they're ICE or EV. I think that is important. I think those trends I mentioned, as long as they remain the sort of industry trends, that actually is very favorable for us regardless of what vehicle type is being manufactured. I think EV will continue to grow, maybe not at the pace that people thought a couple of years ago or the pace we've seen over the last several years, though that certainly is favorable for us on the environmental side.

Meta Marshall: Just in the -- you just mentioned kind of the emissions standards that should go into place in 2026 I think you said in the U.S. I know in the past you've kind of noted whoever is in charge in Washington can kind of impact those. Is that 2026 date firm or do we need to kind of be mindful of what administration is in charge?

Edward Schlesinger: I guess we probably always need to be mindful of that. But to the best of my knowledge, I think we have a relatively high confidence that some form of regulation will come into play in the next several years which is favorable for our business.

Meta Marshall: All right, perfect. Maybe turning to specialty materials, this has continued to outgrow smartphone market in general. Or continuation of your guys' themes where you don't need growth in your end markets, just need growth. Does continued innovation in Gorilla glass help continue the trajectory of this business? Or do we need to see opportunities like foldable phones, AR/VR headsets become a meaningful portion of the market to get kind of additional growth?

Edward Schlesinger: I think this is a great example for us of what we call More Corning where the devices, the number of devices has actually declined significantly. If you go back to 2016, the number of units of smartphones is down about 20%. Our Gorilla sales are up about 40%. I think we will continue to innovate and add content in the cover glass space. It could be Gorilla glass, it could be other glass compositions, ceramics, etc. And I think that will help us to continue to grow on the glass side in the specialty materials segment.

Foldable, bendable/foldable -- to the extent that becomes a standard in the industry, that's also very favorable and certainly would add revenue dollars for us. AR is certainly also an opportunity. I think those things would be compounders and allow us to grow at a faster rate to the extent that the adoption level was high. But I think that remains to be seen. How does bendable, how big does foldable become? How big is AR going to become and over what time period?

And then maybe the only other point I would add is that in this segment, we have a business which we call advanced optics which makes specialty glass for other industries. For example, the semiconductor industry, we're actually seeing nice growth there. We make glass that goes into the equipment that makes semiconductors, so as the semiconductor supply chain continues to grow, that's an opportunity for us to grow in the segment as well.

Meta Marshall: Perfect. Rounding out those segments, we haven't talked a lot about the Hemlock business. This has been kind of a meaningful driver over the past couple of years. Maybe a little bit of pullback of late. Can you just kind of give us what you're seeing in terms of the Hemlock business and how you're kind of thinking about that business?

Edward Schlesinger: Yeah, as a reminder, Hemlock makes polysilicon for both the semiconductor industry as well as for the solar space. We're one of only a few companies that have the ability to make semiconductor grade polysilicon. We're continuing to see nice growth there. We have really long-term take or pay contracts in that space. It's a nice business, generates a nice amount of income and cash flow. And we expect that to continue to grow with the industry.

And then in the solar space, we were not in that space actually if you go back to like 2019/2020. We took advantage of the opportunity to produce what we would call clean polysilicon and reenter that market. We've seen a nice increase and we've actually built a relatively sizable solar polysilicon business. And we see that as an opportunity to continue to grow that into that future, especially as the U.S. looks to build out a solar supply chain, a domestic solar supply chain. We look to participate in that.

Meta Marshall: Okay, and then rounding out on life sciences, you noted that some of the inventory digestion is kind of coming to an end. But it was obviously a big business during COVID and ramping through the pandemic. Just how are you guys thinking about some of the opportunities in life sciences?

Edward Schlesinger: I think obviously during COVID, the industry shifted significantly to COVID-related testing and treatments. And we're seeing the shift back to sort of research and other things in the space. There was definitely a lot of labware consumables inventory that built up. We've seen that begin to deplete in North America and in Europe. Not quite yet in Asia or specifically China where COVID testing went much longer and they built up a much larger inventory. I think we should start to see this business return to growth. We also, as I mentioned earlier, there are certainly some subsegments of various different industries that should grow faster than the average. I think a business like a low to mid-single digit industry growth rate, but there are some bioprocess and gene therapy, things like that, that might grow faster, so there are some opportunities there for us as we go forward. And I think with respect to the supply chain, we'll see that sort of normalize over time, like it's not an abrupt normalization.

Meta Marshall: Okay. Given the current demand conditions, you noted that Corning has the capacity to drive about $3 billion in incremental sales with kind of minimal investment. Just how would you characterize CapEx investment needs over the next couple of years? And how does this broaden or impact your broader capital allocation strategy?

Edward Schlesinger: Appreciate this question. We think this is probably the most important point even though it is I think relatively straightforward for us. We clearly have depressed demand and we have the capacity to supply significantly more than we're currently supplying. And we preserve that because we think that's great opportunity without us having to add capital, which is typically not how we would grow. We're typically adding capital when we need to grow. We can support more than $3 billion of sales relative to our current level without really any capital or even fixed costs so that the impact of a lot of that is already in our financials. You've got depreciation for example on the assets we have in place, so we think that's a great opportunity. And we -- when we did our call in January, we talked about our CapEx for 2024 being less than what we did in 2023 and we ramped that down as we exited the year. Our maintenance capital is $1 billion, $1.1 billion, depends on sort of what we have to get done at any one point in time. Yeah, we might be slightly above that level, but I don't see us needing to spend more capital to support that incremental sale certainly in the 2024 timeframe.

Meta Marshall: You just mentioned when we were talking about the display business and kind of the impact of the price increases, you talked about kind of trying to manage to a net income to sales level. I think in the past, Corning investors have thought about a gross margin benchmark as how they're measuring how you get to those. How much -- and that has changed over time as to whether there's a gross margin benchmark or kind of a net income benchmark. What do you think of as just how you're managing to the business? Is it to a net income threshold that we should be thinking of now or gross margin still?

Edward Schlesinger: I think you can certainly still continue to use gross margin as a good gauge. We exited the year at around 37%, and if you think about us having raised price over time, cost goes up, price goes up, your gross margin percent actually goes down. So that has an impact, kind of a drag on your percentage. I think we'll accrete up from the 37% as we add back volume. But what I think I'd like to highlight, and for me personally this is an important thing, is that we've regulated our operating expenses and we would say there's a leverage point there as we grow back. The thing about using net income let's say versus gross margin is you capture that OpEx leverage. It is certainly another way for investors to think about it. We haven't necessarily given you a benchmark for the total company. We've done it for display because we don't share the gross margin level for each of our businesses externally, so it's just a good proxy for that. But I think investors can still continue to look at gross margin and I think we should expect to see our operating margin percentage accrete up which gives us multiple leverage points.

Meta Marshall: Another investor question we get sometimes is you clearly talked about this $3 billion worth of capacity that you already have. I think there were kind of plans for other facilities that are on hold, whether that be the Arizona fiber facility, I think there have been talks of additional kind of glass facilities in the past. Just are there anything that we should be mindful of as we get to multiple years out when demand comes back that could be kind of areas of increased capital investment?

Edward Schlesinger: I think maybe the way to think about it is, to support this incremental sales, this greater than $3 billion, we don't really need additional capacity. If there are other things that are not included in that, we may need capacity and certainly we'll share that with investors. But the way we think about it is, we always want to derisk that investment. We do that through setting a return on invested capital target of greater than 20%. We look for like take or pay or long-term contracts to do that. We like to use other people's money, so people sometimes will give us deposits or we'll get incentives from various different jurisdictions. And we'll continue to use those tools to ensure that we get a good return to the extent we need to invest capital.

Meta Marshall: And I didn't put this on the original list of questions, but just given AI is kind of the thematic theme here and that you have seen a little bit of a pickup in kind of what you're seeing from hyperscalers, is there a way you can contextualize for the audience just in terms of either density that you see with AI datacenters or just how you guys use the kind of AI opportunity within Corning?

Edward Schlesinger: Yeah. We view it as a significant opportunity. I think it's probably early to determine sort of the relative size of the opportunity relative to either the overall optical business or our enterprise or hyperscale business. But certainly, if people do what they say they're going to do or potentially going to do, we'd have an opportunity to potentially double the capacity in that area over time. It's a significant opportunity. Now that said, I will be cautious and I would caution everybody that people don't always do what they say they're going to do. Or it just may take time for that to happen.

Meta Marshall: Okay, and are there any ways in which Corning is using AI internally as you're looking for OpEx leverage? Or still early days on that?

Edward Schlesinger: I think early days for us, yeah.

Meta Marshall: Any questions from the audience? A question back here.

Unidentified Speaker: Thanks. I had a question. You mentioned earlier, in the beginning, about some ways for you to increase price wouldn't show up in revenue. Could you give me an example of one of those ways?

Edward Schlesinger: Sure. You could give someone free product.

Meta Marshall: Okay. All right. Everybody is going to mind bend to think of that. We have another question.

Unidentified Speaker: I have a question about your sourcing of like high-grade silicon. Where does the majority of that quality silicon come from? Do you get it from China, or where do you --

Edward Schlesinger: I'm sorry, I missed the beginning of your question. Can you please ask --

Meta Marshall: Where do you source your high-grade silicon? Does the majority of it comes from China or Japan or where do you multisource?

Edward Schlesinger: I do not think we provide that information externally. I'm not going to. I don't know that we've ever provided that externally, so I'm not going to answer that. Sorry.

Unidentified Speaker: What's your return on invested capital goal for the business? And help us understand how you get there. And to the extent that you provided this, what do those ROIC numbers look like across the different segments? Thank you.

Edward Schlesinger: Our goal is to be in the low teens, low to mid-teens for the total company. We have not provided it for each of our businesses, but in some cases we have higher fixed costs than in some of our businesses. So obviously, those would be on the lower end. But the lower fixed cost businesses would be on the higher end.

Meta Marshall: Then maybe just as a last question, you've been very successful in kind of driving more Corning content across the end markets. But what areas of the portfolio do you see as most likely to be an area where you would potentially look at M&A or look at inorganic opportunities?

Edward Schlesinger: Our primary focus for capital allocation is to grow organically. And then to the extent we're successful, we want to return cash to shareholders. That's the capital allocation model we run. We are certainly opportunistic in the M&A space. I think in the optical space or life sciences space would be 2 places where we would look to do M&A to the extent opportunities presented themselves. But again, I think of that as being more opportunistic than the primary objective of our capital allocation approach.

Meta Marshall: Perfect. Ed, thanks so much for being here today. It's been a great discussion.

Edward Schlesinger: Thank you. Thanks for having me.