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Q2 2021 McAfee Corp Earnings Call

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PRESENTATION

Operator

Thank you for standing by, and welcome to McAfee's Q2 2021 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference over to your host, Vice President, Investor Relations, Eduardo Fleites.

Eduardo Fleites *McAfee Corp. - VP of IR*

Good afternoon, and thank you for joining us today to discuss McAfee's second quarter earnings results for the period ended June 26, 2021. Participating on today's call are Peter Leav, President and CEO; and Venkat Bhamidipati, Executive Vice President and Chief Financial Officer; and Ashish Agarwal, Senior Vice President and -- of Strategy and Corporate Development.

Earlier this afternoon, McAfee issued a press release announcing its financial results. While this call will reflect items discussed within that document, for a complete information about our financial performance, we encourage you to read our 2020 annual report on Form 10-K for the fiscal year ended December 26, 2020, and our quarterly report on Form 10-Q for the fiscal quarter ended June 26, 2021, which we filed today with the Securities and Exchange Commission.

Before we begin, I want to remind you that matters discussed on today's call may include forward-looking statements related to our operating performance, financial goals and business outlook, which are based on management's current beliefs and assumptions. These forward-looking statements reflect our opinions as of the date of this call, and we undertake no obligation to revise this information as a result of new developments that may occur. Forward-looking statements are subject to various risks, uncertainties and other factors that could cause our actual results to differ materially from those expected and described today.

For a more detailed description of our risk factors, please review our most recent annual report on Form 10-K and our quarterly report on Form 10-Q filed today with the Securities and Exchange Commission, where you will see a discussion of factors that could cause the company's actual results to differ materially from these statements.

A replay of this conference call will be available on our website under the Investor Relations section.

I would also like to remind you that during the call, we will discuss some non-GAAP measures in talking about McAfee's performance. You can find a reconciliation of those measures to the nearest comparable GAAP measures in our earnings release.

Before I pass the call over to Peter, I would like to remind everyone that due to the announcement on March 8, 2021, regarding the signing of the definitive agreement to sell the Enterprise business, the financial results of the Enterprise business were classified as discontinued operations in our condensed consolidated financial statements, and are, thus, excluded from continuing operations for all periods presented. As such, we will focus on continuing operations for our Consumer business on this and future calls.

I will now turn the call over to Peter Leav, McAfee's President and CEO.

Peter A. Leav McAfee Corp. - President, CEO & Director

Thank you, Eduardo, and good afternoon.

Before we move to our quarterly results, we are very pleased to highlight that on July 27, we completed the sale of our Enterprise business for \$4 billion in cash. This was a major accomplishment, and I want to take a moment to thank the team for working diligently over the past several months to make this happen. As we look forward, we are excited about our journey as a pure-play consumer cybersecurity company.

Now to our quarterly results. Q2 was another strong quarter for McAfee as we significantly increased revenue, profitability and free cash flow. We drove very strong performance during the first half of the year, with double-digit year-over-year growth for both revenue and adjusted EBITDA. As a result, we are increasing our FY '21 guidance.

In Q2, we delivered revenue of \$467 million, an increase of 22% year-over-year as compared to the same period last year. Adjusted EBITDA for the quarter was \$218 million, up 38% versus the same period last year, representing a margin of 47%. The adjusted EBITDA for the period included stranded costs of \$21 million.

We continue to drive double-digit growth, along with improved profitability, through our differentiated product and omnichannel go-to-market strategy. Consumers are increasingly adopting our powerful online protection services.

In Q2, we added organically another industry-leading 556,000 net new core direct-to-consumer subscribers, or DTC, to our platform, closing the quarter at a cumulative 19.4 million versus 16.6 million core DTC subscribers in the same period last year. This marks our 15th consecutive quarter of sequential and year-over-year core direct-to-consumer subscriber adds.

In addition to these strong operating results, Q2 highlights included signing a multiyear extended agreement to McAfee's long-standing partnership with Samsung to protect Samsung PC users' personal data against online threats worldwide via our McAfee LiveSafe product. Our unique omnichannel go-to-market strategy continues to allow McAfee to outpace the competition, attracting subscribers at the emanation point and throughout their digital journey.

Furthermore, from a product perspective, on May 31, the German antimalware test lab, AV-TEST, awarded McAfee's Total Protection Top Product Certification for the sixth consecutive time. Additionally, on June '21, AV Test also awarded McAfee's mobile security for Android a perfect score for the seventh consecutive time.

We continue to execute on our plan as we strike the right balance between investing to grow and capture the tremendous market opportunity in front of us while improving margins. We remain committed to invest in our product portfolio, go-to-market engine and subscriber acquisition and retention motions and plan to continue to drive double-digit revenue growth over the long term. We are confident in the sustainability of this trajectory driven by the positive market forces tied to the proliferation of personal devices and data, educational, social and professional use adoption, the evolving threat landscape as well as increased public awareness of the importance of privacy, identity protection and security.

As we look out over the second half of the year, we are confident that the flywheel effect of our business will continue to benefit from a greater renewal base associated with the trailing 12-month cohort of 2.8 million net new DTC subscribers added as of the end of Q2.

We understand the mission-critical role that we play in securing consumers' digital lives around the world. The acceleration in digitization that has taken place over the past year has only served to compound that urgency. McAfee's expertise in bringing differentiated security solutions to consumers has never been more timely. New convenience is in the realm of work, learn, shop, bank, exercise and stream have gone from nice-to-haves to must-haves. These digitally enabled experiences have become permanently woven into consumers' daily lives, and they expect every interaction to be secure. McAfee is there to provide that peace of mind.

Thank you once again to our McAfee team for your dedication and hard work, which has allowed us to focus on customer and partner

success, execute on our strategy and deliver very strong Q2 results.

I will now turn the call over to Venkat to discuss our financial results in further detail.

Venkat Bhamidipati McAfee Corp. - Executive VP & CFO

Thanks, Peter, and good afternoon, everyone.

For today's discussion, I'll be focusing on our non-GAAP continuing operations, unless specifically stated, otherwise. Also, you'll find a historical view of our continuing operations within the supplemental financials on the IR section of our website.

As Peter mentioned, we're pleased that we have closed the transaction to divest our Enterprise business, and moving forward, we'll be focused exclusively on our pure-play Consumer security business. I'll later explain the impact of this transaction on our results.

We continued our strong momentum in Q2, with double-digit growth in revenue, profitability and cash flow year-over-year. Overall results exceeded expectations driven by strong execution and increased demand for our holistic personal security offerings. For the second quarter, revenue was \$467 million, a year-over-year growth rate of 22%, driven by strong public awareness of the importance of security, identity and privacy. Direct-to-consumer revenue contributed \$344 million, an increase of 17% over the same period last year, continuing a strong double-digit growth trend.

We also continued to see robust demand for indirect and partner-led business, which includes mobile providers, ISPs, search, retail and e-commerce partners. Revenue from indirect and partner-led channels, which is a mix of both subscription and nonsubscription, contributed \$123 million, an increase of 38% over the same period last year. This increase was primarily driven by the overperformance of our nonsubscription business.

Adjusted EBITDA was \$218 million, up 38% year-over-year, representing EBITDA margin of 47%. Excluding \$21 million of stranded costs, adjusted EBITDA would be \$239 million, representing a 51% EBITDA margin. Finally, adjusted EPS for second quarter was \$0.28.

Moving to spending. We continue to increase operating leverage in our business model. As a percentage of revenue, adjusted gross margins for the second quarter improved by approximately 200 basis points year-over-year due to product mix and cost of sales efficiencies. Adjusted operating margins improved by approximately 600 basis points as a percentage of revenue. Even though investments increased in product and customer acquisition as compared to last year, we continue to find leverage in our model.

Our pure-play consumer business continues to show widespread strength as we address the increasing demand globally. We saw robust demand in subscriber growth across all geographies, with Americas region contributing \$309 million and leading the group with a growth rate of 23% over the same period last year. EMEA contributed \$109 million, growing year-over-year at 21%, while APJ contributed \$49 million and grew 17% over the same period last year. Our team continues to execute well, focusing on customer acquisition, conversion and retention.

In Q2, we ended with an industry-leading 19.4 million core DTC subscribers, including 556,000 net new subscribers added in the most recent quarter and 2.8 million in the last 12 months. We believe this reflects the sustainable shift towards digitization of consumers across their online activities, which reinforces the need for the type of online protection McAfee provides.

Average revenue per customer, or ARPC, in Q2 was \$5.99, up \$0.04 from Q1, which reflected the growth and mix of new to renewal subscribers across all geographies. From a retention perspective, our dollar retention rate, or DRR, remained at 100%. Our team's excellent execution through a deliberate focus on user experience, value of our offerings, ease of renewal and upselling higher value-added packages continues to contribute to DRR.

Now turning to balance sheet and cash flows, which include results from continuing and discontinued operations. We ended the second quarter with \$420 million in total company cash and cash equivalents. We declared a regular dividend in the amount of \$0.115 per Class A common share on June 10, 2021, and paid it on July 9, 2021. From a cash flow perspective, we generated \$189 million in total company

cash flow from operations compared to \$117 million in the prior period, an increase of 62%. The improvement is attributable to increased profitability and improvements in management of working capital.

Finally, total company unlevered free cash flow was \$233 million versus \$180 million in the previous period, a year-over-year increase of 29%. This is inclusive of approximately \$50 million in onetime costs.

Before providing guidance, I wish to remind investors that a portion of our indirect and partner-led revenue is derived from our search partners and is nonsubscription in nature. While we overperformed in Q2 within this revenue source, it is normally seasonally lower in Q2 and Q3.

Now turning to guidance. We are providing current quarter and annual guidance ranges for the revenue and adjusted EBITDA for our continuing operations pure-play Consumer business.

For the third quarter ending September 25, 2021, we expect revenue and adjusted EBITDA to be in the range of \$461 million and \$467 million and \$169 million and \$175 million, respectively. We expect our direct-to-consumer subscription revenue to increase sequentially from Q2 to Q3. We estimate stranded costs to be in the range of \$35 million to \$40 million. Furthermore, we anticipate cash interest expense for the third quarter to be in the range of \$45 million and \$50 million. And you should assume a fully diluted share count of approximately 470 million shares.

For the full year ending December 25, 2021, we expect revenue and adjusted EBITDA to be in the range of \$1.84 billion and \$1.85 billion and \$765 million and \$775 million, respectively. For FY '21, we now estimate annualized stranded cost to be in the range of \$120 million and \$125 million. This is \$25 million to \$30 million lower than previous expectations as we have successfully eliminated some of the stranded cost and continue to make progress separating the businesses.

Cash net interest expense is expected to be in the range of \$185 million and \$195 million, which incorporates the decrease in debt attributable to the \$1 billion paydown from the proceeds of the sale of the Enterprise business. For fully diluted share count, you should assume approximately 470 million shares.

For the third quarter FY '21, the normalized non-GAAP tax rate for continuing operations is expected to be 22%.

As a pure-play consumer-focused company, we have a highly attractive Consumer subscription business with industry leading scale, double-digit growth and high profitability in a growing personal security market. McAfee's sophisticated product platform and loyal long-term relationships constitute sustainable competitive advantage. We're committed to the success of our customers and positioning McAfee for long-term growth and profitability. We look forward to reporting our continued progress to you over time.

Before turning it over for Q&A, as Peter mentioned, we recently closed the \$4 billion sale of our Enterprise business. Our Board of Directors have declared a special dividend of \$4.50 per Class A common share to be paid out to shareholders with the record date of August 13, 2021, and we're currently in the process of paying down \$1 billion of debt.

With that, I'll turn the call back to the operator to begin Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Rob Owens of Piper Sandler.

Robbie David Owens Piper Sandler & Co., Research Division - MD & Senior Research Analyst

Obviously, getting a lot of investor questions relative to some consolidation in the competitive landscape. So maybe if you want to address from a broad stroke just how you think about some of the consolidation that's occurring, how you guys think about customer acquisition, especially on the international front.

And I guess subscription models versus premium models, and would McAfee pursue something similar? Or do you think that your customer acquisition strategy is where you're going to go, mainly through the OEM channel, some of those MSPs?

Peter A. Leav McAfee Corp. - President, CEO & Director

Rob, it's Peter. Thanks for the question.

So we start where we've typically started, as we've talked to you in the past, and that is -- this is a very big, growing and important market, and it continues to be the case. So for us, it's not really zero sum. We don't look at it exclusively in that sense. And obviously, we're very, very pleased with the fact that we are continuing to do what we've outlined we would.

We grew at a 20% clip last year. We grew over 20% in Q1. We grew over 20% in Q2. And by the way, EBITDA has grown commensurate or better with that. All of our geos are growing at a very, very healthy rate, and all of our channels are growing. And that's a real statement about the team, not only operationally, but also strategically, how we've thought about it and how we think about the consumer and what consumer needs are.

So as it relates to consolidation, that's fine for us. Again, we feel very good about our strategy, our ability to execute. And we see a massive TAM in front of us that is going to continue to need what we do.

Related to the global component, yes, all of the geographies, as we outlined in Venkat's prepared remarks, grew nicely. And that's great to see as well with Americas above 20% and EMEA above 20% and APJ in the teens. So very, very solid performance. We see opportunities to continue to drive growth and drive profit and, importantly, be there for consumers.

And as you asked about channels, by all means, our OEM channel is terrific. We, as you know, are representing 85% of the brand-name PCs and represent the vast majority of the volume, but the other channels have also been terrific growth engines for us, inclusive of our direct channel, which is really a nascent piece for us because so much of our website was dedicated to Enterprise until fairly recently, and that's been a great growth engine, in addition to the long-term retail relationships, which are a great feeder.

Venkat mentioned this nonrecurring business in search, which has grown incredibly well, and MISIP is a growth story for us, too. So again, we feel very good about the routes we're going and what we're doing across the globe.

Robbie David Owens Piper Sandler & Co., Research Division - MD & Senior Research Analyst

Great. And then as a follow-up, how should we think about ARPC expansion as DTC adds slow? And more specifically, I guess, the pace of that expansion.

Venkat Bhamidipati McAfee Corp. - Executive VP & CFO

Rob, this is Venkat. With respect to ARPC, as you know, ARPC is up \$0.04 quarter-on-quarter. We're very pleased with the sequential increase in ARPC. Certainly, as you alluded, the higher mix of renew helps ARPC. And our team is incredibly focused on driving long-term value to customers, both through upsell and ability to continue to sell value to our customers through holistic packages.

So over time, we expect all cohorts to increase ARPC in the long term. And certainly, with a large install base, we think of that as a large opportunity in front of us.

Operator

(Operator Instructions) Our next question comes from Brian Essex of Goldman Sachs.

Brian Lee Essex Goldman Sachs Group, Inc., Research Division - Equity Analyst

I was -- maybe if you could perhaps give us a little bit of color into net DTC adds. It looks like it kind of decelerated quarterly, more in line with maybe what you've seen historically. Could you maybe talk a little bit about demand and retention rates and how we should think about net adds going forward?

Peter A. Leav McAfee Corp. - President, CEO & Director

Brian, it's Peter. So why don't I start with retention, and then we'll talk about DTC and the 556,000 that were added, which clearly was industry-leading. From a retention standpoint, the DRR is very healthy. So DRR was up 200 bps year-over-year, but call it, 100%. With the amount of new subscribers that we bring in, in the mix of first year, it's just continued strong performance on that front. So the retention rate remains solid, and we feel very good.

As far as the addition of new subscribers, 15 consecutive quarters year-over-year and sequential is a very positive sign of the future, really, because with the flywheel of this business and what happens in year 2 and beyond, it's just very, very strong for us.

Now related to things like ARPC, we don't want to rush and improve ARPC at such a fast clip that we cause a cessation of growth of new. So 17% in what we would call a seasonally softer quarter, which Q2 and Q3 are. I know you recall, Q4 and Q1 are more robust, that's a solid performance from this team. And the good news as well is it's coming from a variety of mechanisms. The direct channel is growing nicely. The OEM feed into it is growing nicely. And the indirect side of the business is also doing really well.

So it's a very balanced business today, and we're going to continue to drive more and more of that. But no, I think it was a solid performance for the quarter.

Brian Lee Essex Goldman Sachs Group, Inc., Research Division - Equity Analyst

Okay. Appreciate that. And maybe just a follow-up on that point, one level deeper. I mean are there any kind of like macro trends that you're attributing that to? Is it more efficient DTC spend? Are there things from the consumer standpoint that are driving more consumer adoption of the platform? How should we think about that just as we eye growth going forward?

Peter A. Leav McAfee Corp. - President, CEO & Director

Well, at a macro level, it's very clear that the behavior for consumers is forever changing, and we've seen that again and again in the digitization of all of our lives. And that's not a one-off or that didn't happen by chance as a sugar high. It's just the way people are going to start continuing to behave and have been behaving of late, whether that's interaction with your health care provider or ordering food online or how folks opt to bank, whereas that wasn't as pervasive a few years ago, and there's been a hastening of that for reasons that I think are obvious.

And we see, by the way, a greater degree of focus from those who are trying to exploit that, and that's going to continue. And it's unfortunate, but the world of cyber criminal behavior continues to expand as well.

Now for us, one of the things that's important in a differentiated fashion is a group that probably doesn't get enough accolades at McAfee, and that's our McAfee Threat Labs team. I mean we have telemetry around hundreds of millions of endpoints, and we have a gauge on not only consumer behavior, but importantly, cyber criminal behavior, and it's only getting bigger. And that's going to continue. And I think around the world, folks understand that, and consumers and their families understand it. So at a macro level, that's a phenomenon that we expect to continue.

Operator

Our next question comes from Hamza Fodderwala of Morgan Stanley.

Hamza Fodderwala Morgan Stanley, Research Division - Equity Analyst

I guess your, Peter, first question for you. I guess in light of the recent announcements, let's say, I'm wondering from a capital allocation standpoint and sort of a longer-term growth standpoint, like to what degree does M&A kind of fit into McAfee's growth strategy now that you're obviously a pure-play consumer security company?

Peter A. Leav McAfee Corp. - President, CEO & Director

You bet. And Hamza, you know this is a very, very strong cash-producing business, and Venkat's outlined that. And Ashish has outlined that in the past, and that continues to be the case. We're going to be very responsible. We've obviously, I think, done a reasonably good job of giving some of that continuation, inclusive of the \$4 billion that we just solidified on the 27th of July back to shareholders, both as

dividend and, obviously, debt paydown. So we're going to be balanced and responsible.

Now related to the M&A component, I think broadly speaking, what we'll continue to assess, while we feel very good about our organic play, which obviously we're going to continue to be very focused on, and we like what the team is doing and the size of the TAM, but we're going to look at what we call accretive growth areas. Those would be the types of things we would look at, both from a technology and market potential standpoint, and look at that with the lens of what enables us to continue to grow. We're very growth-oriented while driving profitability. And clearly, that's been the case, and that's the type of results-driven mindset we have.

Hamza Fodderwala *Morgan Stanley, Research Division - Equity Analyst*

Got it. And just maybe a quick follow-up. Just some of these extension agreement that you signed with the likes of Samsung and others. To what degree are there additional growth opportunities there in that -- was it that previously you were just protecting sort of traditional PC devices, and now, you're getting more into smart home device? Like anything around that in some of these renewal agreements that you have with the OEMs.

Peter A. Leav *McAfee Corp. - President, CEO & Director*

Sure. And these are long-term agreements, and I appreciate your asking. So part of it is the market itself continues to expand beyond PCs as well, which obviously impacts the mobile channel, et cetera. But we're seeing with renewals, and the Samsung example is an important one, it's really a LiveSafe renewal. So it's not just one product component. And as you look at what we've been doing -- and I would say we probably haven't marketed this to the extent that maybe we could or should. But between McAfee LiveSafe and Total Protection, it's really less about features and functionalities, and it's more about an amalgam of offer that consumers are looking for.

We've enhanced our McAfee security app with the package with secure VPN, with identity protection, with safe browsing, with WiFi scan. We've enhanced our story related to the proportion of our business that is now being sold as LiveSafe and Total Protection. It's a broader range.

The other thing that's really interesting for consumers, and this is across channels, including direct, is we came out with -- and this is just this past quarter, our McAfee protection score. And that enables consumers -- as we've queried consumers and studied consumers, most consumers do not know how safe they are. They know whether or not they have McAfee, and there's a degree of assurance and insurance that they have, but how do they know whether or not they're safe online?

And so what we've done is we've produced a protection score, think of it somewhat akin to like a Z estimate, to provide personalized feedback and help you and your family know whether you're in a safe situation. And it's really, we think, going to help us with even greater engagement in a nonintrusive way.

So yes, VPN expansion, all of those are on the docket, but we look at it with a solution mindset rather than kind of throwing features at the market. And we think there's going to be an opportunity to not only broaden the aperture and the number of DTC subs but also back to the question about ultimately ARPU and ARPC improving over time. That'll come from a broader solution set as well. So probably more of an answer than you wanted, but that's what we're focused on.

Operator

At this time, I'd like to turn the call back over to CEO, Peter Leav, for closing remarks. Sir?

Peter A. Leav *McAfee Corp. - President, CEO & Director*

Great. Well, thank you all for joining our call today. We look forward to updating you on our next call. Thank you.

Operator

And this concludes today's conference call. Thank you for participating. You may now disconnect.

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