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PRESENTATION

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

My name is Amanda Scarnati. I'm one of the semiconductor analyst here at Citi. I'm joined by Steve Kelley, the CEO, and Paul Oldham, the CFO of the Advanced Energy. We're going to do a little fireside chat this afternoon. So let's just start off, just kind of setting the stage on Advanced Energy, it's quite a different company than it was last time we were in person here at Citi. I think the last one we were in person here at Citi, you might have just been starting as CEO. So just give us an overview of where we're sitting today?

Stephen D. Kelley - *Advanced Energy Industries, Inc. - President, CEO & Director*

Yes. Just as a way of introduction, Advanced Energy Industries is roughly $1.5 billion a year revenue company. What we do is we supply highly engineered precision power solutions to industries such as semiconductor capital equipment, industrial, medical, telecom and networking. And so what we do is we focus on a part of the market where customers need something extra. So we're focused on custom solutions and modified standard products. What that does is it produces a superior margin profile. So our normalized gross margin, excluding some of the supply issues that we're dealing with is roughly 40%. The percentage of our revenue, which is sole source is roughly 70%.

And so what we're trying to do over the coming years is move that sole-source percentage from 70%, closer to 80%, and that will drive progressively better gross margins over time. We're a relatively low capital intensity company. We spend usually less than 3% of revenue on CapEx per year. So our fixed costs are relatively -- well, most of our costs are from our bill of materials. So we have been impacted by the supply shortages over the past 1.5 years, but I think we've gotten a lot better at dealing with our supplying issues. We've done a lot in the past year to improve our performance there.

We've gotten better at some of the blocking and tackling, dealing with brokers and other dealers and finding some of these scarce parts paying the premiums. But we've also done a lot of work on the engineering side. We've qualified a lot of new alternative products, which are easier to find and also redesigned a number of boards that are oriented towards easy to find part. And so we're actually seeing meaningful impact now in the second half of this year, including Q3, where we could generate meaningful revenue based on these redesigns and that's starting to differentiate us relative to our competition.

QUESTIONS AND ANSWERS

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

Just kind of pick up on that supply chain story, I think the biggest comment that we get from Advanced Energy on earnings is over supply constrained. The demand is fantastic, but supply constraints are still there. Can you just talk about what is still causing the supply constraint issues outside of the things that you've done to ease some of them, and how long do you think these headwinds will continue on for?

Stephen D. Kelley - *Advanced Energy Industries, Inc. - President, CEO & Director*

Yes. So just to be clear, our supply constrained [term] was 100% ICs and discrete products. So silicon essentially. And these are older node products. So these are basically the same products that are purchased by the automotive customers and other industrial customers. That's who we compete with for these integrated circuits. If you take a look over the last 6 months, our list of problem ICs has diminished. So it's probably half the size that it was 6 months ago as far as the sheer number of products that we're chasing, but we have some pretty persistent issues. And so that's how we continue to pay large amounts of money to brokers to procure these integrated circuits.

Looking forward, it's difficult to predict exactly when the crisis is going to pass because it's a sum total of a lot of different problems out there at different suppliers. But one thing you do notice, if you look at the electronics industry is that inventories have reached all-time highs. So there are a lot of companies like Advanced Energy, they're sitting on a lot of inventory. And these are for all the ICs that aren't scarce, it's the other stuff, it's 95% of ICs that we can get readily.

So we have warehouses full of ICs. And so what you're seeing now is a transition, where a lot of companies, including Advanced Energy, are stopping the purchase of those other ICs, and really focusing on the scarce products. And so that is going to create more capacity for some of the scarce items, and that's what's going to resolve the supplying crisis once and for all. It will happen sometime over the next 6 months.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

I think one thing that investors have really appreciated a lot about Advanced Energy over the last, let's say, 6 months or so with the stock really driving up has been the backlog and the strength of the backlog. I think it's at about $1.2 billion as of last quarter. But you also were able to shift more out of the backlog than you expected in the June quarter. Can you just talk about the build versus ship rates in that backlog, and how much of that is due to increased customer demand versus customers just ordering earlier in order to sort of stay ahead of the curve?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

And maybe I can talk to that. So you're right, Amanda, last quarter, our second quarter, we overshipped our expectations by $45 million. So it was a very good quarter from an output perspective for us, it was a record quarter in revenue. And yet our backlog grew another 15% on top of that. So the demand levels continue to be very high even as we get better at solving the supply challenges. And when you look at the backlog, historically, we would run $300 million or so in backlog. But we're almost at $1.2 billion today. And I think that illustrates the fact that we've had very strong demand across our markets. We continue to see that. And even while we resolve supply constraints, the demand has been solid.

Now when we look at that backlog, we're pretty optimistic about it. If you look at the overall backlog, it only represents 12 months of backlog. It's very short term, more than 2/3 of it has customer requests stay within the next 6 months, so people continue to escalate us and depress to get products sooner. And Steve mentioned that our business is 70% proprietary. Our backlog is actually almost 80% or a little higher percent proprietary. So these aren't products that have multiple customers putting the orders onto the same products. It's products that are essentially sole sourced to us. So we think that, that backlog represents a couple of things. One, if the demand continues to stay robust, then it represents significant financial upside to the company as supply improves. Demand softens a little bit. It should be a significant buffer for us to continue to maintain a high level of financial performance and even grow despite some softening in the in-demand markets if that would occur.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

So I guess the flip side of that is the concern that investors have over what percentage of the backlog is potentially cancelable versus what percentage is take-or-pay and committed to actually having to be purchased?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

In our markets, the backlog can be rescheduled or it can be canceled, we typically don't have noncancelable orders with our customers. But because its sole sourced because the demand has continued to run high practically, we've never seen what we would think of traditionally as cancellations in our backlog. But typically, what we would see is we would see the demand level come down as people consume the parts that they've been asking us for today. And as I mentioned, we have to see a pretty significant drop in the demand levels for us to actually see a reduction in our revenue levels from current levels today. And practically, we think that actually represents more upside in revenue for us over the next several quarters than anything else.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

So talking about the demand environment, we're seeing some mixed trends here, consumer is obviously quite a bit weak, we're starting to see some weakness in enterprise, we're starting to get some early indications of maybe there might be some weakness in auto and industrial markets. Advanced Energy is in multiple different markets. Can you just talk about the different dynamics that you see in each of your end markets based on the different exposures that you might have?

Stephen D. Kelley - *Advanced Energy Industries, Inc. - President, CEO & Director*

Yes. I think first, speaking broadly, going back to Paul's comment about our backlog, we overshipped Q2 by almost $50 million, but our backlog still grew 15%. So we're at a record backlog of close to $1.2 billion now. So that, I think, speaks to the near-term demand. And that's broad-based. It's not just one of our segments. It's across semiconductor, industrial, medical and telecom and networking. So there's a lot of pent-up demand. And I think you need to think about what's happened over the past 1.5 years where we've undershipped into the market. We've been struggling to meet the demand for the last 6 quarters, essentially because of these parts issues that have been pretty persistent.

Now as the parts issues resolve themselves, we can unlock some of the value in that backlog. There's a lot of pent-up earnings sitting there in our warehouses waiting to get shipped out to customers in the form of our power delivery solutions. That's going to happen over the next 4 quarters. So we're very bullish about 2023. I think there's going to be a combination of healthy demand plus a catch-up on our existing backlog. Now as far as what we're seeing today from our customers in the various segments, in semiconductor, which is our biggest market at roughly 50% of our revenue today.

Our customers are telling us they've got solid visibility through next year and that their business will continue to grow with us over the course of 2023. And we see that in their manufacturing plans as well. So the demand is good despite the concerns about the memory market, we need to be mindful that the memory market is roughly 40% of the market today of the overall semi cap equipment market. It used to be a lot higher. And so there are other segments, which are based with leading-edge logic and then everything else, all the other logic, the older technologies. And the capital intensity in lean is logic, is impressive.

Just a sheer amount of equipment, the fabs need to buy to manufacture these latest logic chips is really incredible. A number of layers, number of process steps has gone up a lot over the past 5 to 10 years. And so that drives leading edge. On the trailing edge, what you're seeing is the pervasive use of ICs throughout all markets. And that's driving demand and will continue to drive demand for those older technologies where you don't need leading edge, you just need good enough. So that's semi equipment. I think with industrial and medical, we're seeing a lot of demand there. And because they're so diverse markets, industrial, medical, we just see a lot of upside.

And for us, it's a market share gain opportunity because industrial medical is an area where we're relatively low share today, single-digit market share. And we haven't really focused on it until last year. It was kind of a byproduct of acquisitions and some of our technology. But now we've been focused on it in the past year, both our sales team as well as our engineering team, and we're seeing doubling, maybe a tripling of new design opportunities in industrial and medical.

So that's really both, I think, a market that's going to grow overall as well as where we're going to gain share. And then the last market, the telecom, networking, hyperscale markets, we're really focused on changing our portfolio there and reducing our exposure to commodity type opportunities, picking hyperscale and increasing our exposure to sole-source opportunities. And so for those customers in telecom, networking, hyperscale, we're really focused on improving the bottom line in that segment and less focused on growth.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

Let's start diving into each of these segments a little bit more deeply. So first, just picking up on the semiconductor side, where you mentioned that memory is about 40% of the market and other things are driving growth. From Advanced Energy's perspective, how much exposures you have to each of the end markets, is it similar to what the industry is or do you have greater exposure in one or the other?

Stephen D. Kelley - *Advanced Energy Industries, Inc. - President, CEO & Director*

Yes. We don't know these things with precision because obviously, we sell our customers and they sell to their customers, and we don't track every system that we sell. But what I can tell you is our strength isn't something called conductor edge.

And if we look at logic, the logic market, that's where conductor edge is most important. And so whether you're talking about the leading edge logic or the trailing edge logic, conductor edge is the dominant edge system. In memory, it's different. Memory is more focused on dielectric edge systems. That's where we don't play in a significant way. And so when memory goes down, we don't feel it as much as some of our competitors.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

But you have been looking into the dielectric and the new plasma or the remote plasma opportunity as well and bringing products to the market. Can you talk a little bit about how that is trending and what you're seeing as your opportunity and how that's going in terms of qualifications?

Stephen D. Kelley - *Advanced Energy Industries, Inc. - President, CEO & Director*

Yes. So what Amanda is referring to is there are 2 markets that are basically all upside for us. So I mentioned we're the dominant player in conductor edge. We have very low market share in dielectric edge and remote plasma source. And so we've introduced technologies to the dominant customers in those markets of dielectric and remote plasma source. Those customers are actively evaluating our technology.

And that's how you gain share in this market. You need to have some differentiating technology, which we think we have. So we think we have a good share of establishing a strong foothold in both markets. You'll see that in our revenue probably 2 to 3 years from now because it takes time for these things to go from evaluation to qualification to full production.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

Historically, the semiconductor market has seen really big swings on the CapEx side, especially for the component suppliers. So you tend to significantly outperform on the upside and then the downside tends to crash very hard. How are you thinking about how this market is going to look for you over the next couple of years? Do you think that the cycle could be different because of the supply-constrained environment that we've been in?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

I think it's a very different setup this time than it's been historically because you're right, Amanda, typically, we're at the end of the WIP. And so the biggest inventory corrections that our customers affects our products and we see we grow, we decline faster in the downturns and we grow faster in the upturns. But this last upturn has really been a supply-constrained upturn. The result of that is there's not the typical inventories that have been built up at our customers.

In fact, we've trailed their demand every quarter, including last quarter. And so when we look at the inventory levels they have with their products, they're very low and in some cases, nonexistent. When we look at spares, they've used a lot of their spares to meet customers' demand. When we look at the inventories that are in the distributor and other channels, they're much lower than historical levels.

And particularly given what Steve just talked about going forward, a desire to have maybe a little extra inventory just in case inventory, we believe there's a meaningful amount of inventory that needs to be restocked even in a slower environment because it's very disruptive for our customers to operate in this fashion. They would much rather have a reasonable stocking level of inventory that they can pull just in time. In fact, our largest customers have you basically stock our products for just in time pulling of that.

So for them, it's a 0 lead time, we just maintain the buffer levels. But those buffer levels or those stock levels are essentially depleted significantly from historical levels. So we think the setup this time is different that we should have more buffer, if you will, as those stock levels get replenished than what we've seen historically.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

So when we spoke earlier this summer, you had mentioned that some of those safety stocks have been being able to be built up in certain product areas. Can you just talk about what areas you're seeing stock actually improving versus what areas are still extremely supply constrained?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

Yes. I think there are a few pocket areas where the stock levels are getting -- they are improving somewhat, but I would say, the vast majority are still short from historical levels, and many are still handing out. So there's still, we believe, a meaningful upside opportunity for us as supply normalizes, we can actually get back to a more normal operating environment with our customers.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

And then the last question on the semiconductor side. There have been quite a bit of CapEx cuts on the memory side, and we're expecting to see further cuts as well. How are you building that into your expectations for second half of the year and into 2023?

Stephen D. Kelley - *Advanced Energy Industries, Inc. - President, CEO & Director*

Yes. We really haven't seen a meaningful change in the demand profile. And I think what you're seeing is that lead times in the semi cap equipment space are pretty long right now, typically longer than 1 year. And so I think many of our customers' customers are reluctant to cancel orders. I think they may be moving some things around. But we haven't seen an impact on the demand. In fact, I still spend a fair amount of time every week talking to our customers, and they're basically trying to expedite us. And that's across the board in semiconductor equipment. So the demand we see is still very healthy.

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

I'd add that, so if you look over the last year, and you've seen the projections for WFE come down, they've largely come down as a result of supply constraints. People have been more realistic about what they could actually get and then ship. I think in memory, you are seeing maybe some further reductions from that. But I still think we're still trying to approach a demand and supply balance, which we're not quite at yet.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

Shifting focus over to the data center. Data center has been very strong in the industry, but for AE, it's been quite a bit lumpy over the last couple of years. Can you just talk about what you're doing to further build out this market to make it a little less lumpy and what's happening in that environment today?

Stephen D. Kelley - *Advanced Energy Industries, Inc. - President, CEO & Director*

Yes. I mentioned earlier, in the data center, we're pivoting away from being 1 of 2 or 3 sources to being sole source. So that means we're focusing on different types of opportunities. So today, we are shipping as 1 of 3 qualified suppliers on many different applications. But I think when we sit here 2 years from now, we're going to be talking about a significant shift in our portfolio. And so again, in data center, we're focused on growing our bottom line. And where Advanced Energy excels is where we can apply our engineering expertise, create something different from our competition and get paid for it.

Again, we're a high mix, lower volume type of manufacturing company. What we want to avoid is get into the high volume, low mix situation where we're competing directly with large Taiwanese competitors. That's not a place where we're going to drive great margins. So that's a shift that's going on in hyperscale. I don't see a lot of growth there overall, but I do see a shift in our margin profile that moves it up in the coming years.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

And then we've seen some large OEMs like Dell starting to talk about the deceleration in the data center market. Can you just talk about how this is going to impact AE potentially?

Stephen D. Kelley - *Advanced Energy Industries, Inc. - President, CEO & Director*

I think the data center market is cyclical, always has been, probably will be for quite some time. And so we pay special attention to our piece part inventory for these data center applications. So we pay more attention to that inventory than any other because that's in jeopardy as they go through these cycles.

And so I think that's our defense is trying to manage those piece for inventories very closely. The other thing we've done is we've increased our exposure, so we're not just dependent on 1 or 2 customers in data center, we have broader exposure today so that if they're not all moving in sync, then we have a chance of making up for some lost volume where customers are going through corrections.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

But in the industrial and medical market, medical obviously did really well during the pandemic in 2020, 2021, as you saw more power supply for respirators and things like that. As we look into 2022, 2023, should we expect to see a deceleration on really strong comps or macro risk creating a little bit of a headwind in the medical side of the market?

Stephen D. Kelley - *Advanced Energy Industries, Inc. - President, CEO & Director*

Yes. The way we view the medical market is that there are some strong growth vectors. In particular, we think the medical market is moving back to a normal state where there's investment and procedures and diagnostics. Some of those investments versus spend during COVID essentially. So we're seeing our customers reengage and our customers' customers reengage. The other thing we're seeing is Advanced Energy is we made a fairly significant acquisition in April of a company called SL Power. So SL Power, it was a good company, generating gross margins of roughly 40%.

Now 60% of those revenues when they brought to the company were into medical and 40% with industrial. So as we have combined the SL Power Medical business with Advanced Energy's legacy medical business, we have now become the #2 or #3 supplier into the medical power market. And SL Power's customer base was very complementary to Advanced Energy, our customer base. Their strengths were customers where we didn't participate and vice versa. And so there's been a lot of good cross-selling that started already at AE's customers and at SL Power's traditional customers. So we think that acquisition is going very well. From a financial standpoint, Paul will tell you, it's playing out a little bit better than expected so far.

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

Yes, that's right. When we look at SL Power, it's really a perfect reflection of our strategy. It's in end markets that we like a lot. It's very complementary to our current portfolio and allows us to add scope of these products and customers and then leverage our broader scale as a company. So we're on track with the integration. We've seen very good response from customers as we started to do cross training with our sales force and get into these additional customers.

We're well on our way to the integration, which we -- we shifted our philosophy to do more, quicker integration to be able to achieve the scale and bring things closer together more quickly and look at, I think, historically, SL's had very good reputation in the market, but they're a little undercapitalized due to the PE ownership. And they had very little international reach, both of which we bring significant strengths and from a product and capability perspective, from being long-term players in the market and having a quite strong international reach with our products.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

And then continuing into the industrial space, how should we think about growth, is it GDP plus type growth, should we be concerned about decelerating macro and risks in consumer markets and other general industrials?

Stephen D. Kelley - *Advanced Energy Industries, Inc. - President, CEO & Director*

I think the way to think about industrial is it's a pretty broad category, and it's hard to generalize. But I think if there's one metric, it would probably use GDP plus, but we sell into a lot of different markets, and they're all value-added markets where, again, they're willing to pay extra for some customization. The way we view industrial is it's an area where we only have single-digit margin share today. We have tremendous upside, not just because the market is growing, but also because we're going to grow share.

And that's a result of the focus I talked about earlier from the sales side and the engineering side. Industrial is a different type of market because most of the opportunities are relatively small. In semiconductor equipment, we're swinging for the fences every time essentially. But in industrial, you're hitting a lot of singles and doubles. And so it's labor intensive. But we like it because it ends up being sole source in this very long life cycle. Most of these customers keep buying our products for 10, 15, 20 years. So it's a great foundation for the company.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

And the last piece of the portfolio, which doesn't get nearly as much love is the base station business. So could you just remind us a little bit about [buying] the 5G transition is mostly over at this point. But how should we think about growth in that piece of the portfolio?

Stephen D. Kelley - *Advanced Energy Industries, Inc. - President, CEO & Director*

Yes. So I think in the market we play in, which is non-China, essentially, the 5G build-out is still happening, which is good. So the customers we sell to are doing fairly well, and they're participating in particularly in the U.S. and Europe in the 5G buildout. And so we see that as a steady market. We don't think we're going to see explosive growth there, but we see it as part of our baseline over the next couple of years.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

And then, Steve, you talked in your opening remarks a little bit about margins. But maybe, Paul, you can dive into a little bit more about the margin progressions and the key drivers that will improve those margins above that 40% number?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

Yes. As you know, Amanda, we have a target gross margins of 40% or better. And frankly, before the supply chain crisis even as recently as Q1 a year ago, we were essentially right at that 40% just under. With the supply chain crisis, we've seen significant increase in our material costs. The main area where that's occurred is what we call these material cost premiums where we're paying substantial multiple on the part cost because we're having to buy the cost for the part on the open market from brokers or dealers or other sources, not from our normal supplier.

And we're paying enormous premiums, and I'm sure you've heard stories about this, we experienced all of those. Now we've been able to get our customers to reimburse a portion of that. But if you put it all together, that's 200 to 300 basis points of impact to gross margin just related to those premiums. Now as the market normalizes and we can actually get these parts from our regular suppliers, that's going to dissipate. And it should dissipate pretty quickly because it's not normal that we would be paying many multiples of the part cost from a broker instead of getting it from the supplier.

That will get us pretty close to 40% just on its own. In addition, there's actual inflation. We're paying more for parts, generally, where prices have increased or paying more for our people. In those cases, we believe we can pass those costs along to our customers in a more systematic way and recover that cost.

In addition, we'll have our own things we've done around redesigns or efficiency improvements that will help to mitigate and offset that. And then finally, frankly, our factories aren't very efficient right now. We've maintained our workforce at full force, even though we've not been able to output at our full capacity because we want to have burst capacity when we do get parts. We think there's a lot of catch-up to do in our backlog, which should drive higher volumes. And frankly, it's still a talent war. So we don't want to lose people that might be harder to replace later.

So we've made some conscious choices about keeping that workforce in place. That's probably another 100 basis points that naturally normalizes as our business grows and we were able to actually ship to a normal schedule instead of these constant reschedules depending on what parts we get. So when you add that all up, it puts us easily over 40%. And our goal is to be over 40% in both good markets and bad. So we want to overshoot that target a little bit as we go forward. And when we look over time, we don't see any structural reason why we shouldn't be able to perform at that level.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

I think one concern that a lot of investors still have, maybe newer investors, I should say, so have in the story, is the shift in the margin profile after you acquired Artesyn, and that dragged down margins quite a bit because of the different structure of the 2 businesses. Can you just talk a little bit about what's left to sort of squeeze out of that Artesyn restructuring and gain synergies there or are we done at this point?

Stephen D. Kelley - *Advanced Energy Industries, Inc. - President, CEO & Director*

I think we're doing it. So when I joined the company in March of last year, we took a look at the portfolio and the industrial medical margins were pretty impressive, including the ones from Artesyn as well as some of the legacy industrial medical business from Advanced Energy. So that's why we formed new business units to really focus on those 2 areas, industrial and medical. So now we have dedicated business units with business unit managers dedicated engineering, dedicated marketing to really grow those businesses.

We also looked at some of the other business, which is hyperscale and then telecom networking. And frankly, some of the margins there weren't as impressive. And we had too many engineers and too much effort focused on hyperscale, not enough in industrial medical. So we shifted a lot of engineers from hyperscale into industrial medical, The turbocharge to product effort on the I&M side. We also reoriented the sales force. So we took roughly half of our sales and FAE force and changed their goals. And that half of the company or the company's sales force is now solely focused on industrial and medical design wins, and revenue. And before, there was just part of their goal, now it's the 100% of their goal.

And so this has really resulted in a tremendous increase in design opportunities for the company. And we can win these opportunities more often than not because typically, our competition in industrial, medical, are smaller customers. They're not as well funded, they don't have the same technology base we have, and they certainly don't have the same manufacturing expertise we have. And so we can generally win those opportunities where we bring our resources to bear in industrial medical. And it's a better competition set than in hyperscale.

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

I might add to that, Amanda. From a historical context, you're right, when we were primarily a semiconductor equipment company, our margins were around 50%. When we bought Artesyn, our blended margins dropped to 33%. And we said our goal is to get over 40% as we integrated the business, did some of the portfolio rationalization. We essentially achieved that in the first 18 months before the supply chain crisis.

And the broader company now gives us a much bigger footprint in industrial and medical and ability to scale and grow earnings, not just ride the cycles up and down, grow earnings over time, that was the primary thesis. So we think we're well on that road. The thing I would add is because of the supply chain crisis, we haven't actually gotten to all the manufacturing synergies that can be had, which can further increase improved gross margins over time. So we feel very confident in our ability to see margins over 40% for a top-tier industrial technology company. We think that's very respectable. And we have a platform that can grow revenues and now earnings over time in a much more sustainable way than we've historically had.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

See if there's any questions in the room about -- [Mike, right] over there. So it picks it up on the webcast.

Unidentified Analyst

Why are you sole source, why do customers say, "I only want to buy from you guys." I don't mean to say that you've been an unreliable customer or provider over the last few years, but now they see that risk of having a sole-source provider. Why will you remain at 70% sole source, and why will you be able to go to 80%, what do you do better than your competitors that your customers have to buy from you?

Stephen D. Kelley - *Advanced Energy Industries, Inc. - President, CEO & Director*

Yes. I think it's a different answer depending on the market. So in semi equipment, our primary business is supplying power delivery systems for plasma chambers. And it's a very difficult technical problem to solve, and it involves working very closely with our customer. So we'll deliver a certain capability and then we'll go back and forth with the customer over the course of many months to tune that capability to the characteristics of their plasma chamber in their particular processes.

And that's how you get to be sole sourced because it's very difficult to do that over multiple suppliers. So the key for us is bringing the right technology to the right customers and then having the bandwidth to spend a lot of time with that customer to perfect it. That's how it works in semiconductor. In industrial & medical, it's a little bit different. The technical challenges aren't quite as significant as they are in semi equipment. You're not trying to light up a plasma chamber. But the customers need a certain combination of characteristics. And typically, that combination will not be found in a standard product.

Now we may have a standard product that comes close, but the customer needs XYZ, they need special EMI characteristics in a special form factor. This thing needs to survive 300 drops in on a drop test. It's just unusual things, but they're particular to an application. And so that's where we come in, and that's how we customize it. We say, okay, we can reengineer this thing, either it's going to take us 2 weeks or it's going to take us 6 months, but we'll create this special product that meets the needs of your application.

And in return, we become sole source, and they just keep buying it for a long time. But again, it's a different type of proposition. So we have over 1,200 development engineers in the company. It's a lot of people. And that's what they do. They work on these opportunities with customers and they perfect them for the customer application. But more often than not, it turns out to be a sole-source product when we're done.

Unidentified Analyst

I think I have 2 for you. First is, how do you think about your capital allocation priorities, and I guess the second is, would you have a think about end market consolidation because it sounds like industrial and medical is higher growth, maybe even higher margin business, but then you also have parts of the portfolio where you've probably squeezed out as much as you got good on gross margins, and you're already below 40%, and that's where investors want you to go, So is that something that you would consider or are working towards, those are my 2 questions?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

So I'll take capital allocation quickly. So we do generate a lot of cash, and we have a very strong balance sheet. It's our #1 priority with capital allocation is to grow the company. We're in a large market. It's very fragmented in our ability to acquire companies that add scope that we can then leverage our scale is very attractive to us. So we've done, I think, 7 acquisitions in the last 2.5 or 3 years, that will continue to be a big part of our strategy. We also had an opportunistic share repurchase program. We know our stocks can be a little bit cyclical.

And so we look for opportunities and dislocations in the market where we can acquire more shares. In general, our goal is to offset dilution, but practically, we've been able to actually reduce the share count over the last few years because we've been opportunistic in the market. And then third, we do pay a dividend. It's $0.10 per share, it's a very modest yield, but it's about 10% of free cash flow roughly. And we think that's just a way to demonstrate that we have the cash and the ability to return cash to shareholders over time. From a market consolidation point, do you want to comment on that, Steve or do you want me to continue?

Stephen D. Kelley - *Advanced Energy Industries, Inc. - President, CEO & Director*

Yes. I think the question was really more of a product consolidation one. So traditionally, where we feel margin pressure, we would try to reduce the cost first so that we can create more margin. That's been very difficult in the current environment because our costs are going up, not down. And so that leaves us with 2 choices. One is to raise price and the second is to obviously the product if we're trying to improve the mix over time.

And so we have been able to pass on price increases to our customers. We did that in the fall of last year, and we did it in a very transparent way. We showed them the increase in costs that we are experiencing, primarily on the integrated circuit side, but also in other parts of our system. We're paying more for metal, wires, you name it, everything is going up. And so we basically were able to pass on the price increases to most customers. They're also helping us with these, what we call, piece-part variance prices where we have to pay extra to brokers and dealers for particular ICs.

So I think over time, that's what you'll see from us is we've shifted the engineering resources into higher value-added sectors like industrial, medical and semiconductor. We've reduced resources and some of them were difficult parts of the market. And then those engineering resources that are left are really focused on sole source and highly differentiated opportunities within hyperscale telecom networking. So we're not going to be chasing commodity opportunities.

Amanda Marie Scarnati - *Citigroup Inc., Research Division - VP & Semiconductor Consumable Analyst*

All right. Well, I think we are out of time, so Steve, Paul, thank you so much, and enjoy the rest of your day here.

Stephen D. Kelley - *Advanced Energy Industries, Inc. - President, CEO & Director*

Thanks, Amanda.
