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PRESENTATION

Operator

Greetings. Welcome to Advanced Energy's Third Quarter 2021 Conference Call. (Operator Instructions)

Please note, that this conference is being recorded. At this time, I will now turn the conference over to Mr. Edwin Mok, Vice President of Strategic Marketing and Investor Relations. You may now begin, sir.

Yeuk-Fai Mok - *Advanced Energy Industries, Inc. - VP of Strategic Marketing & IR*

Thank you, operator. Good afternoon, everyone. Welcome to Advanced Energy's Third Quarter 2021 Earnings Conference Call. With me today are Steve Kelley, our President and CEO; and Paul Oldham, our Executive Vice President and CFO. If you have not seen our earnings press release, you can find it on our website at ir.advancedenergy.com. There you will find the third quarter slide presentation.

Before I begin, I'd like to mention that we will be participating at several investor conferences in the coming months. Let me remind you that today's conference call contains forward-looking statements that are subject to risks and uncertainties that could cause the actual results to differ materially and are not guarantees of future performance. Information concerning these risks can be found in our SEC filings. All forward-looking statements are based on management's estimates as of today, November 8, 2021, and the company assumes no obligations to update them. Medium- and long-term targets present today should not be interpreted as guidance.

On today's call, our financial results will be presented on a non-GAAP financial basis, unless otherwise specified. Excluded from non-GAAP results are amortization, stock compensation, integration and transition costs, unrealized foreign exchange gains or losses and restructuring items. A detailed reconciliation between GAAP and non-GAAP measures can be found in today's press release.

With that, let me pass the call to our President and CEO, Steve Kelley.

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

Thank you, Edwin. Good afternoon, everyone, and thanks for joining the call. In the third quarter, we delivered results above the midpoint of our guidance. Stronger factory output pushed our revenue, gross margin and earnings per share to the upper part of our guidance range. Demand remains extremely robust across all of our target markets. In addition, our new products continued to be well received by customers, who depend on AE's innovative technologies to achieve their efficiency, power density and precision power goals.

We remain focused on the key factors driving our long-term success: industry-leading innovation; strong customer relationships; outstanding quality; a strong leadership team; and a culture focused on results and speed.

Over the course of the year, we have taken substantial steps to increase the capabilities of the Advanced Energy leadership team. Our latest addition to the team, Eduardo Bernal, joined the company in September as our EVP and COO. Eduardo has an impressive record of achievement in the semiconductor industry with specific expertise in operations and supply chain management. Before joining Advanced Energy, he led the global back-end manufacturing organization at NXP Semiconductors, and was able to drive significant performance improvements over a multiyear period. Eduardo will be based in Singapore and Malaysia, and we are delighted to have him on board.

Now I'd like to touch on our supply chain challenges, specifically shortages of key ICs. These shortages continue to constrain shipments and limit our financial performance. We are working diligently and with a high sense of urgency to mitigate the shortages, expediting suppliers, qualifying replacement parts and where necessary, redesigning boards to eliminate problematic ICs. Many of our customers are playing an important role in the mitigation efforts by expediting qualifications of new parts and by joining discussions with our key suppliers.

We are seeing some incremental progress on the parts front, as reflected in our third quarter performance. However, the overall supply environment remains dynamic. With little slack in the supply chain, the effects of manufacturing or shipping disruptions quickly ripple through to the end customer. Given the dynamic nature of the supply chain issues, we are taking a relatively conservative approach to our financial forecast. However, given the amount of pent-up demand for our products, as indicated by our record backlog, we see considerable revenue and profit upside tied to the successful mitigation of our supply constraints.

Despite the supply chain issues, we have maintained a full factory workforce, in order to maximize our surge capacity. As an additional measure, we plan to keep our Shenzhen factory open into the second quarter of 2022.

Now I'd like to provide more color on each of our target markets. As I mentioned earlier, demand is very robust across all of our markets. The macro trends are solid, and customers are designing in our new products. In the Semiconductor Equipment space, our customers are forecasting strong unit growth in 2022 across a wide range of technologies. We are well positioned to benefit from this growth given our strong position in both current generation and next-generation conductor etch equipment. In addition, we expect to gain share in the coming years in plasma power applications, particularly in areas where we currently have a minor presence, such as dielectric etch and remote plasma source. Our new eVoS and MAXstream products for those applications are being evaluated and qualified by multiple customers, and are expected to go into mass production in the coming years.

In the third quarter, we secured several strategic wins at Korean and Chinese OEM customers. We also won an important remote plasma source design. In medical, we secured several wins in life science and therapeutic applications, and a strategic win in ultrasound. In industrial, we secured a high-profile win in the thin film area and received a large order for an indoor farming project. We also won several proprietary designs in power control and thermal sensing applications.

In Data Center Computing, Telecom & Networking, we continue to see strong demand as multiyear digital transformation trends drive sustained infrastructure investments. In the third quarter, we secured a next-generation hyperscale design with a solution featuring power density roughly double that of current generation products. We also won high-value designs in telco edge, storage and network writing applications.

Before closing, I'd like to summarize our key messages. First, demand for our products is robust. I made broad customer acceptance of our new products and technologies. Second, we are working diligently to mitigate the impact of supply chain constraints. Third, we expect pent-up demand for our products to drive several quarters of revenue upside above current run rate as supply chain issues are successfully addressed. And finally, we are positioning the company for sustained revenue growth with a strong lineup of differentiated products, targeting the right markets.

Paul will now review our financial results and provide detailed guidance.

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

Thank you, Steve, and good afternoon, everyone. In the third quarter, we delivered revenue and earnings above the midpoint of our guidance. Total revenue of $346 million declined 4% sequentially as our ability to ship products was limited by component supply and to a lesser extent, COVID restrictions in Malaysia. Relative to our guidance, gross margins were at the high end, resulting in earnings of $0.89 per share. Customer demand remains high, and we entered Q3 with record backlog of over $770 million. The vast majority of this backlog is for proprietary products, and roughly 2/3 is for orders that are shippable as soon as we can build them, highlighting the strong demand profile. We believe this high level of shippable backlog represents meaningful upside to our current revenue levels for an extended period of time as the supply situation improves.

In the near term, the availability and predictability of certain components, primarily critical ICs remains challenging, and we expect supply constraints to continue to gait revenue. In addition, as we projected, our gross margins are being impacted by higher input costs in the form of premium buys, expedite fees, some price increases and underutilization of our factories. The majority of these costs are transitory and will naturally improve over time. But we are also taking proactive actions to mitigate the headwinds on both availability and cost, which we expect to begin yielding results in Q4 and increase over time. These include working with our customers on cost recovery and pricing, establishing strategic supply agreements with our suppliers and pursuing selective redesigns.

During this time, we are retaining our factory capacity to be able to deliver higher revenue as parts become available and expect to maintain our broader infrastructure about flat, while reallocating resources to accelerate our most important programs. While we will see some inflationary pressure in spending, we believe this approach is a good balance between managing short-term challenges and funding an extended set of opportunities for upside and long-term growth. As revenues recover, we expect to see good operating leverage and continue to believe we have the building blocks in place to achieve our medium- and long-term goals.

Now let me go over our Q3 revenues by market. Semiconductor sales continued near record levels at $173 million, up from last year, but down slightly from last quarter. Demand remains strong. And with Malaysia now allowed to operate at full capacity and modest improvement in parts supply, we expect Q4 semiconductor sales to grow sequentially.

Revenue from our industrial and medical markets fell 3% from Q2 to $81 million. However, customer demand was broad-based, and our backlog increased by almost 50% sequentially. We saw revenue strength in thin film coatings, medical and thermal sensing, where our teams were able to overcome some of the part shortages. Data Center Computing revenue was $62 million and Telecom & Network revenue was $30 million, both down from last quarter due to supply constraints, which have been particularly acute for ICs used in these markets. Our order book in these 2 markets continues to increase.

Non-GAAP gross margin for the quarter was 36.1%. The sequential decline was primarily due to increased input costs and factory underutilization. Year-over-year, these costs are having an approximate 350 basis point impact to gross margins. While we are making progress on mitigating actions and cost recovery, we expect margins to continue around these levels for another quarter or so as the higher cost materials roll through inventory and impact our cost of goods sold.

In addition, as Steve mentioned, we now plan to extend the operation of our Shenzhen factory through the end of Q2, which will impact gross margins in the near term, but provide additional shipment flexibility. Non-GAAP operating expenses were $83.6 million, up about $1 million from last quarter. The sequential increase was mostly due to a full quarter of expenses from TEGAM, which we acquired in June. Operating margin for the quarter was 11.9%. Other expense was $1.7 million including $1.3 million of interest expense.

We expect other expense to be in the $2 million range going forward, including the interest cost on our additional debt. Our non-GAAP tax expense was $5.6 million or 14%, which was largely in line with our target of approximately 15%, plus or minus. Earnings for the quarter were $0.89 per share compared to $1.25 last quarter.

Turning now to the balance sheet. We ended the third quarter with total cash of $550 million and net cash of $153 million. Operating cash flow was $18 million and CapEx was $8.5 million. During the quarter, we repurchased $52.6 million of common stock at $86.93 per share, taking advantage of market volatility to return cash to shareholders. We also paid $3.9 million in dividends.

Earlier in the quarter, we amended our existing credit agreement to increase our term loan by $85 million to $400 million, increased our undrawn revolving line of credit to $200 million and extend the remaining term to 5 years. With an attractive rate of LIBOR plus 75 basis points, this refinancing provides us with additional financial flexibility for inorganic growth, share repurchase and other corporate needs.

In Q3, our days of net working capital increased to 117 days. Inventory increased by $45 million and turns were 2.8x as we continue to acquire raw material to support future shipments. We believe this inventory is well matched to customer demand. And although it may take a few quarters, we expect turns to rebound as critical part shortages abate. Days payable fell to 76 days based on timing of payments. On the other hand, DSO improved to 57 days on strong collections.

Now let me turn to guidance. Market demand and our order book continued to be extremely strong. However, we expect the supply environment to remain challenging in the near term. As a result, we expect Q4 revenues to be approximately $355 million, plus or minus $20 million. Our Q4 guidance assumes semi revenue will grow sequentially. We expect Q4 gross margin to be similar to Q3 based on higher material costs offset by incremental benefits of mitigating actions.

Operating expenses should be flat to up slightly largely due to the cost of inflation across a variety of areas. As a result, we expect Q4 non-GAAP earnings per share to be $0.92 plus or minus $0.25 based on a share count of approximately 38.2 million shares.

We are taking a prudent approach for the next couple of quarters, assuming that the current supply environment will continue to limit revenue at around current levels in the near term. However, we are confident that our mitigating actions will yield incremental benefits in the coming quarters. With our large shippable backlog, we expect to see revenue upside of up to $50 million per quarter over our current run rate as supply normalizes.

Looking forward, we are more excited than ever about our expanding set of new opportunities, and we'll continue to invest in R&D to accelerate our growth. As we take mitigating actions to manage component availability and cost, continue to optimize our portfolio and rationalize our factory footprint, we expect to achieve gross margins at or above our long-term goal of 41%. We remain focused on executing our strategy and are confident in our ability to reach our long-term revenue and earnings goals.

With that, let's take your questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from the line of Tom Diffely with D.A. Davidson.

Thomas Robert Diffely - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

Paul, just following up on your last comment, you talked about revenue going up possibly $50 million a quarter once supply constraints ease. As you talk to your suppliers, when do you think that starts? I mean when do you see an end to the IC supply issues?

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

That's a good question, Tom. I think the challenge we have is in the near term, we continue to see these critical parts being in short supply. But we have a highly engaged -- work with our supply chain, also with our customers to try to accelerate and increase the amount of parts. And while it's hard to say exactly when that will turn around, we do believe that over the course of next year, it will improve. I think it's very possible by the time we get to the end of next year, we could be seeing revenues running at that level, current levels plus $50 million, which would be significant for us. We believe that could drive earnings power at that time as high or maybe higher than $6 a share annualized.

Thomas Robert Diffely - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

Okay. That's very helpful. And then when you look at your 4 segments, could you kind of rank them in order of which ones are being the most affected by the supply constraints?

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

Yes. The ones that are being most affected are higher volume markets, particularly the embedded power markets. These particular products use a higher number of these critical ICs. There's also more standardization across those products. So if you're short on one these critical parts that might, in fact, impact multiple families.

Probably the second most impacted is our industrial and medical products. And then semi is actually performing quite well. As you see, we continue to operate near record levels. But certainly, there are critical shortages there as well, and we could be doing much better if we had the parts in place.

Thomas Robert Diffely - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

Great. And then finally, when you look at the -- you talked about qualifying new parts to get around some of the IC shortages, how long does that process take?

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

Yes, Tom, this is Steve Kelley. We started that process in earnest 3 to 4 months ago for a number of our products. Typically, that price is going to take around 9 to 12 months to do the redesign, to do the reliability testing, get the qualification from our customers. The good news for us is that our customers are highly motivated to qualify these new designs. So we're seeing a record turnaround time. So it's possible we get the calls done a bit quicker than we expect.

Operator

The next question comes from the line of Krish Sankar with Cowen and Company.

Krish Sankar - *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

I have 2 of them too. First one, Paul, I just want to follow up. You said that the revenue upside of $50 million a quarter, maybe happen later next year that supply normalizes. But on the same path, how long do you think the gross margin or this component cost increase going to be a drag on gross margin? Is it beyond 4Q into 1Q or beyond that too? And then I have a few other follow-ups.

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

Yes, I said in our prepared remarks that we thought this would last a couple of more quarters. Certainly, we have a lot of these premium buys, expedites that are rolling through now. And some of that's in inventory. So that certainly is impacting Q4 and will likely impact Q1 as well. As we look beyond that, it will depend on how quickly we can move to a more stable supply level where we're paying more normalized parts for these -- more normalized prices for these parts.

So it's difficult to say in the near term, but certainly over the course of the year, we'd expect to see some improvement. Probably the simplest way to think about it is probably -- the situation probably persists for another couple of quarters and then gradually improves from there. We don't see a silver bullet Krish where suddenly magically things get much better.

But we've done a lot to take mitigating actions, including working with our customers on cost recovery, on sharing some of the price changes that we're seeing. We're working with our suppliers to have better long-term agreements and sources of supply, which should hopefully get us out of some of the premium buys and things we're having to do through distribution and other channels. And as volume begins to improve, obviously, that helps our factory utilization as well.

So all those factors will contribute to margins getting back to where we'd like them. It's interesting, if you look at the actual numbers, it's pretty clear that if you excluded the higher cost of materials we're paying in the near term and the impact on our factories, we're certainly running at or around that 40% level. So some of these are transitory. The premium buys will pass more quickly. Some of them will be longer term, and we think there will be opportunity for price and other mitigating actions around redesign that Steve talked about earlier.

But we feel confident as we look out, I think in the last call, we talked the exit rate of 2022, we could be back around that 40% level. We don't have a lot of visibility. Obviously, the timing could change. But that's, I think, not a unreasonable way to think about it.

Krish Sankar - *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

Got it. That's really good color, Paul. And then I just had 2 quick follow-ups. The $50 million incremental revenue, is this fair that you given that -- in your prepared comments, you said there's a lot more supply constraint issues on the I&M Telecom & Networking and data center side. Is the incremental $50 million more tied towards the legacy Artesyn business? Is there a way to think about it and i.e. that's where you might see some price recovery and helping margins as the revenue comes back?

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

Yes. I think it's definitely more of a mix, Krish. There's significant upside in our semiconductor products for a lot of reasons, demand is quite healthy there. And remember, not all of the semiconductor demand is in our backlog because of our -- been strategy with our largest customers. So there's significant upside in the semi as well. It's fair to think that it would affect both -- it would help all of our markets.

Krish Sankar - *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

Fair enough. Fair enough. And then just a final question for Steve. Steve, it seems like -- maybe I'm wrong on this, but I'm just kind of curious, it looks like you're moving away from servicing the hyperscalers markets inside and moving -- shifting more to industry and medical, a, is that true? If so, can you talk a bit about that strategy and how it could impact the long-term revenue margin profile for the company?

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

Yes, Krish, I think it's fair to say the entire company is moving towards higher value-added products. That includes what we're doing for hyperscalers and enterprise computing customers. If we take a look at I&M, the Industrial & Medical group. The most attractive part of that market is it's almost entirely sole source at least for us. And so we have put more engineering horsepower into the Industrial & Medical business, and we expect to grow that at a faster rate moving forward.

Operator

Next question is from the line of Quinn Bolton with Needham & Company.

Nathaniel Quinn Bolton - *Needham & Company, LLC, Research Division - Senior Analyst*

I wanted to follow up on Krish's question, maybe ask it in a slightly different way. If you look at the business today, obviously, there's a lot of pent-up demand. But wondering how much of that affects the Industrial & Medical and semi business versus the more embedded telecom and server businesses? I would think that there may be more perishable demand in those embedded markets.

And so as the business comes back, does it come back faster in Industrial & Medical and semi, which are higher-margin businesses? Or do you think there's actually better growth off a pretty depressed level in the more embedded, but lower-margin businesses that you come through next year?

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

Yes. Go ahead, Steve.

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

Yes. Let me just echo what Paul said earlier. We see shortages across all of our businesses, whether it's semiconductors, industrial, medical and the high-volume hyperscale and enterprise computing businesses. So it's hard to predict which comes back faster, if they all come back at the same time. But I can say that we're working hard in all the businesses to close the gaps. We are paying significant premiums every week to source parts from various distribution and broker channels and working closely with our customers in all the segments to meet their needs. So we really can't predict which market will come back faster than another.

Nathaniel Quinn Bolton - *Needham & Company, LLC, Research Division - Senior Analyst*

Understood. And then the second question, you mentioned keeping the Shenzhen facility opened through the second quarter. Wondering if you might be able to quantify how much of an impact that might have on your fixed expense space. I imagine to the extent you closed that down, that there could be a nice gross margin lift in the second half of next year, especially as revenue at that point should be ramping as you start to meet some of this pent-up demand?

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

Yes, that's right, Quinn. We've said that the cost of keeping that site open from a fixed cost is between 50 and 100 basis points of gross margin.

Operator

Our next question is from the line of Mehdi Hosseini with SIG.

Mehdi Hosseini - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Going back to your Q4 guide, what would be your revenue be if there was no supply chain disruption?

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

Well, I think it's easy to look at that in a hypothetical, say, if there was no parts disruption, you could add that $50 million in today, at least. We certainly have shippable demand that's well in excess of that, where customers will take the products as quickly as we can get them. And then it would be just a matter of manufacturing capacity, which we certainly have enough manufacturing capacity to meet that number. So it's really all about having the critical parts.

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

Yes. Let me just add to that. I mentioned in my prepared remarks that we are maintaining a full workforce in all of our factories. So we have the surge capacity to get well beyond $400 million a quarter in revenue. So we have the people in place. And as the parts appear we could build that equipment pretty rapidly.

Mehdi Hosseini - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Okay. And then you highlighted the growth in semi business in the December quarter versus September? Should I assume that other business units will be flat to down and semis will show growth? Or would the other business units would be flat?

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

Yes, I would say, generally speaking, semi, we expect to be up, probably Industrial & Medical, flat to up, and the high volume would likely be the offset to that. The high volume being Telecom & Networking and Data Center Computing. But look at it, it's all about what parts we get in and where they go. That's the critical thing. So it's a little hard to predict exactly the mix.

Mehdi Hosseini - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

I see. Okay. And just for purpose of modeling and assuming that $50 million of business were to come back throughout '22. Would you have to expand your OpEx? Should I assume that your OpEx would go up maybe $1 million or $2 million per quarter? Or would you keep it kind of flattish from here on?

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

Yes. Our intent is to keep it flattish from here on. We have, as you know, Mehdi, sort of accelerated already investment in R&D because we have a lot of opportunities ahead of us, working with our customers. We're very excited about those. And there'll be a little bit of inflationary pressures. But our goal is to basically keep our infrastructure flat, and then there'll be some inflation on top of that. But we don't need to add a lot of operating costs as revenues grow beyond just kind of your typical variable costs that are completely tied to revenue. So not much OpEx growth as revenues recover.

Operator

(Operator Instructions)

The next question is coming from the line of Pavel Molchanov with Raymond James.

Pavel S. Molchanov - *Raymond James & Associates, Inc., Research Division - Energy Analyst*

You've done a little bit of M&A over the past year, but I'm curious if the supply chain complications that you and everybody else clearly is experiencing might create some distress situations that you could opportunistically take advantage of. Is that a realistic scenario in terms of your -- some of the potential M&A targets?

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

That's an interesting question, Pavel. What we're seeing actually is we have some targets we're looking at, but they don't want to do a transaction because their financials are distressed because of the part shortages. So it's kind of a circle here. So I think as the parts shortages start to abate, I think you'll see the potential for more deals in this space.

Pavel S. Molchanov - *Raymond James & Associates, Inc., Research Division - Energy Analyst*

Okay. So kind of the opposite of what...

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

Yes, the opposite.

Pavel S. Molchanov - *Raymond James & Associates, Inc., Research Division - Energy Analyst*

Okay. Fair enough. Your dividend is now at its 1-year anniversary, congrats on that. Should we anticipate a dividend increase at any point in '22?

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

Yes. Pavel, obviously, that's something that the Board will review on a regular basis. At this point, we're not really in a position to comment on that. But look, our focus right now is on growing our business. We think there's a lot of opportunities to do that organically and inorganically. We're certainly investing a lot in working capital right now to support what we think is that upsize of growth. So we'll take that in stride, but no comments on that at this point.

Operator

(Operator Instructions)

At this time, we've reached the end of the question-and-answer session. And I'll turn the call over to Steve Kelley for his closing remarks.

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

Thanks for joining us today. We are dealing with near-term supply challenges, but we remain firmly focused on the timely introduction of new products and technologies, the drivers of AE's future revenue and profit growth. With strong demand for our products, a record order book and a solid pipeline of high-value proprietary designs, we are well positioned to meet or exceed our medium- and long-term financial targets.

We look forward to talking with many of you in the coming weeks. Thank you.

Operator

Thank you. This does conclude today's conference. You may disconnect your lines at this time. We thank you for your participation.

DISCLAIMER