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Advanced Energy Industries, Inc. (AEIS)

Q1 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings and welcome to the Advanced Energy First Quarter 2024 Earnings Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] And as a reminder, this conference is being recorded.

It is now my pleasure to introduce to you Edwin Mok, Vice President, Strategic Marketing and Investor Relations. Thank you, Edwin. You may begin.

Edwin Mok
Vice President, Strategic Marketing & Investor Relations, Advanced Energy Industries, Inc.

Thank you, operator. Good afternoon, everyone. Welcome to Advanced Energy first quarter 2024 earnings conference call. With me today are Steve Kelley, our President and CEO; and Paul Oldham, our Executive Vice President and CFO. You can find our earnings press release and presentation on our website at ir.advancedenergy.com. Let me remind you that today's call contains forward-looking statements that are subject to risks and uncertainties that could cause 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, May 1, 2024, and the company assumes no obligation to update them. Any targets beyond the current quarter presented today should not be interpreted as guidance. On today's call, our financial results are presented on a non-GAAP financial basis, unless otherwise specified. Excluded from non-GAAP results are stock compensation, amortization, acquisition-related costs, restructuring and impairment charges, and unrealized foreign exchange gains or losses. 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 Douglas Kelley

President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.

Thanks, Edwin. Good afternoon, everyone, and thanks for joining the call. We had a challenging first quarter. Although, semiconductor revenue was stronger than expected, revenue in our other markets was weaker than forecasted. We believe that our revenue shortfall was due largely to pockets of inventory, which developed at OEMs and distributors after supply chain constraints were resolved towards the end of 2023. Although, we expected an inventory correction, we underestimated its magnitude. Despite these issues, we were still able to achieve our gross margin target and deliver earnings within our guidance range.

Our outlook for the remainder of 2024 is more encouraging. In the second quarter, we expect revenue to rebound sequentially, driven mostly by strength in the data center computing market. We also expect to grow in the second half of the year as semiconductor revenue gradually improves, the industrial and medical market begins to normalize, and the data center computing market continues to strengthen. Although, we are carefully controlling spending, we continue to invest in R&D. We are moving full speed ahead, bringing new products and technologies to our customers. Our design win pipeline has never been stronger, and we expect to make meaningful share gains as market conditions improve.

On the manufacturing front, we are executing our consolidation plan, taking advantage of lower factory loading to speed product transfers and qualifications. We expect these efforts to benefit gross margin beginning in the second half of 2024, as lower manufacturing costs start to flow through our P&L. We are operating in a dynamic environment this year, so we need to remain nimble, able to respond quickly to upside demand. To do that, we are maintaining strategic piece parts inventory as well as appropriate factory staffing levels. In addition, we plan to build some finished goods inventory to take advantage of open manufacturing capacity.

Now, I'll provide some color on each of our markets. First quarter semiconductor revenue was slightly better than expected, helped by growth in value-added services. On the design win front, I'm pleased to report that we have secured our first major wins for both the eVoS and eVerest next-generation plasma power products. Over the course of this year, we expect to announce more major design wins, which we believe will drive share gains in the coming years. We have already shipped more than 50 eVoS and eVerest systems, and customers have requested that we ship another 150 systems before year-end.

We are putting a lot of effort into keeping up with the extraordinary level of demand for these new technologies which enable our customers to operate much more efficiently at leading-edge nodes. The modular architecture of eVerest has dramatically shortened the development cycle time for derivative products. Our engineering teams have become more productive, enabling our customers to accelerate the introduction of next-generation etch and deposition systems. For both eVoS and eVerest, we took a modular approach, leveraging our broad portfolio of high-voltage, low-power, RF, and advanced control technologies to bring best-in-class solutions to our customers.

Advanced energy development teams from around the world work closely together to make these products a reality. Moving to industrial and medical where first quarter revenue was impacted by inventory corrections. Design activity in industrial and medical is extremely robust. After three years of dealing with supply chain shortages, our customers are now squarely focused on product innovation and differentiation. Design wins have been broad based, including major first quarter wins in medical imaging, electrosurgery and warehouse automation. In March, we launched our Evergreen high-power platform, which features best-in-class efficiency and power density. Target applications include aerospace and defense, fast-charging stations, industrial lasers and large capital equipment.

Our new industrial and medical products are supported by focused sales teams and our new digital platform, which now includes e-commerce capability. In addition, our quick-turn engineering team works closely with customers to modify and customize our standard products to meet specific application needs. Moving on to data center computing where first quarter revenue was slightly below expectation due to the pushout of a single, hyperscale program into the later quarters of the year. We are forecasting a significant rebound in second quarter revenue, driven by increased hyperscale AI investments and our share gains in enterprise AI servers. Telecom and networking revenue decreased sequentially. Reduced infrastructure investment and high inventory levels constrained revenue. We expect these challenging market conditions to persist throughout 2024.

Now, let me summarize our outlook. We expect the first quarter to be our revenue trough for the year. In the second quarter, we expect that a surge in data center computing demand will drive sequential revenue growth. As we move into the second half, our outlook remains largely unchanged from our last earnings call. This is based on our expectation that conditions in the semiconductor, industrial and medical markets will gradually improve, driving sequential quarterly growth. Customers are embracing our new technologies and products and design-in activity is at an all-time high. We expect that these design wins will drive market share gains in our target markets.

Our manufacturing consolidation plan is on track, giving us confidence in our ability to move gross margins above 40% as markets recover. Finally, with a strong balance sheet, we continue to look for inorganic growth opportunities, which make strategic and financial sense. Looking forward, we believe that the investments we are making in R&D and manufacturing, coupled with potential acquisitions, will accelerate our medium and long-term profitable growth.

Paul will now provide more detailed financial information.

Paul R. Oldham

Chief Financial Officer & Executive Vice President, Advanced Energy Industries, Inc.

Thank you, Steve, and good afternoon, everyone. First quarter revenue declined 19% quarter-over-quarter, driven by a challenging demand environment in our non-semi markets. Despite the lower volumes, healthy product mix and solid execution allowed us to meet our gross margin target. And steps we took to control our operating expenses enabled us to deliver earnings per share of $0.58, which was within our guidance.

The market environment in the first quarter was characterized by higher-than-expected customer inventory destocking and reduced demand at telecom and networking customers. Semiconductor revenue in Q1 was ahead of our expectations. Backlog declined modestly from the end of last year and was in line with our target of slightly more than a quarter of revenue. At the same time, this was the second consecutive quarter of higher bookings, which supports our Q2 outlook for a sequential revenue rebound. Based on some early signs of improvement, we believe our Q1 revenue will be the trough and expect business levels to increase over the remainder of the year.

Now, let's review our financial results in more detail. Revenue in the semiconductor market was $180 million, down 6% sequentially and 7% year-over-year. Results were slightly better than our guidance with sequential growth in services. We continue to expect Q2 revenues around this level with the second half stronger than the first half. Revenue in the industrial and medical market was $83 million, down 23% from last quarter and 32% from last year. The impact of shorter lead times and increased inventory throughout the channel resulted in higher-than-expected levels of inventory rebalancing at both our OEMs and distributors. We expect revenues to remain around this level until inventories begin to normalize in the second half.

Data center computing revenue was $42 million, down 33% sequentially and 30% year-over-year. Although, we had expected lower revenue this quarter, we also saw a single hyperscale program push out into the remainder of the year. However, based on recent order rates driven by increased investments in AI across multiple programs, we expect revenues to meaningfully rebound starting in the second quarter. Telecom and networking revenue declined 48% sequentially and over 50% year-over-year to $22 million, following a very strong 2023 in which customers replenished inventories following the supply chain crisis.

However, demand in Q1 was even lower than our expectations due to further weakening in both the telecom and networking markets, increasing the impact of inventory destocking. We expect these market conditions to persist through the end of the year. First quarter gross margin was 35.1%, down 60 basis points from last quarter and 170 basis points from last year. Results were in line with our expectations, despite the lower volume due to favorable product mix and actions we are taking to lower cost. We expect Q2 gross margins to be at a similar level on higher volumes, but less favorable mix. In the second half, we continue to expect gross margins to increase, driven by our ongoing manufacturing consolidation activities, higher volumes and reduced material costs.

Operating expenses were $93.5 million, down from last quarter and below our target. Q1 was the fifth consecutive quarter that we reduced operating spending, which is down more than 7% from Q4 of 2022 despite the inflationary environment. We will continue to focus on controlling our discretionary spending while investing to support new product and platform activities throughout the year. Operating income was $21 million for the quarter. Depreciation was $10 million and our adjusted EBITDA was $31 million. Other income was $5 million at the high end of our guidance with interest income higher than interest expense consistent with Q4. We expect other income to remain around $5 million per quarter until the swap instrument against our outstanding term loan expires in September of this year.

For Q1, our non-GAAP tax rate was 17.7%, higher than our target of 16% due to timing and geographic mix of profits. We expect the tax rate to remain in the 17% to 18% range for the balance of the year. First quarter EPS was $0.58 per share compared to $1.24 in both the previous and year-ago quarters. Turning now to the balance sheet, total cash and investments at the end of the first quarter was $1.02 billion, with net cash of $106 million. Cash flow from continuing operations was $8 million. Timing of previous year incentive payments, higher inventory on strategic investments and lower revenue impacted our cash flow. Overall, inventory increased $25 million or 7.5% sequentially, resulting in inventory days of 153 in Q1.

DPO increased from 49 days in Q4 to 58 days in Q1. Receivables declined by $35 million on lower revenue, and DSO was up slightly to 68 days. During the first quarter, we invested $16.6 million in CapEx. We continue to expect that 2024 CapEx will be approximately 4% of sales. We also made debt principal payments of $5 million and paid $3.8 million in dividends. Turning now to our guidance. We expect second quarter revenue to rebound from a Q1 trough, driven primarily by a recovery in data center computing. We expect semiconductor revenues to be at similar levels to the first quarter and we expect industrial and medical and telecom and networking markets to be approximately flat as customers continue to rebalance their inventories.

As a result, we are forecasting our second quarter revenue to be approximately $350 million, plus or minus $20 million. We expect gross margin in Q2 to remain at around Q1 levels on higher volumes and improved costs offset by less favorable mix. We expect Q2 operating expenses to increase $1 million to $2 million sequentially due primarily to increased R&D investments to support new product launches and investments to scale the company. As a result, we expect Q2 non-GAAP earnings per share to be $0.73, plus or minus $0.25.

Before opening it up for Q&A, I want to highlight a few important points. Overall, we continue to invest and set priorities with the long-term view of the market, while managing prudently given near term dynamics. Despite the lower results in Q1, we expect revenues to improve sequentially in Q2. In addition, we expect the second half to grow largely as we had previously projected, driven by incremental revenue across several programs and timing of market improvement. Looking beyond this year, we believe we are focused on the right markets with strong customer pull for our highly differentiated products and technologies. As a result, we expect to deliver strong growth and market share gains as markets recover.

Second, we believe earnings for the year will continue to be largely in line with our previous projections. We are executing our plan to improve our gross margins and profitability. We continue to expect gross margins to expand in the second half of the year, reaching our target of 37.5% to 38% by the end of the year as revenue improves. In addition, we expect operating expenses to grow modestly over the next several quarters as we manage our cost structure, while investing in new products and scale to drive future growth. Beyond this year, we believe we are on track to achieve our gross margin goal of over 40% as quarterly revenue recovers to the mid-$400 million range, and to deliver higher earnings than our prior peak as markets recover. Finally, we have a strong balance sheet and are well-positioned to execute acquisitions that make financial and strategic sense.

With that, we'll take your questions. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And the first question comes from the line of Joe Quatrochi from Wells Fargo. Please proceed with your question.

Joe Quatrochi
Analyst, Wells Fargo Securities LLC

Q

Yeah. Thanks for taking the question. Maybe first, just kind of broadly speaking, maybe ex-semiconductor, just trying to understand, it sounds like, inventory destocking was a bit more than expected. So can you talk about just your level of visibility forward and what gives you confidence that we're kind of reaching or finding an end point of some of the inventory destocking as we move through the year?

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.

A

Yeah. Joe, this is Steve. I'll make a few comments. You're right. In Q1, the destocking was a little bit more significant than we originally forecasted. There are two main areas of weakness; one was telecom and networking, and the second was industrial and medical. Telecom and networking, basically, what happened, was a lot of inventory built up at the end of the year. And then we think there's also a demand shift that we saw in Q1. And so we don't expect the telecom and networking market to come back this year. So the real focus for us is on industrial and medical. And with industrial and medical, it's a little bit more difficult because there are a lot more customers. Telecom and networking is just a few big customers and industrial and medical has many customers.

What makes that group somewhat unique is that, they suffered the most over the last three years during the supply chain issues. So they recovered late, probably most people recovered from supply chain issues late 2023, early 2024. And so what those customers encountered over the past three years were very long lead times, a shift in mentality from just-in-time to just-in-case procurement. And then all of a sudden you saw sort of lead time contraction in the first quarter of this year. And so that's really what caused these pockets of inventory. Some of those are in distribution, but many of those are at the end customer and sometimes at their customers. And so that's why it's more difficult to track the exact level of inventory in industrial and medical.

The good news is, we've already seen recovery. We're starting to see a recovery on the medical side and we're seeing some encouraging signs of a move into Q2 and Q3 on medical. Industrial, based on our discussions with customers, with distributors and also analyzing trends in resales, as well as orders from direct customers, we think that's going to start to normalize in either Q3 or Q4 this year. As we look back, we saw the correction start in Q4 in industrial and medical, Q4 of 2023. And so we're in the third quarter of that correction today. That's why we think we'll be out of this sometime in Q3 or Q4 of this year.

Joe Quatrochi
Analyst, Wells Fargo Securities LLC

Q

Got it. Helpful color. And as a follow up, you guys are talking obviously data center computing increasing sequentially, driving the revenue growth there. And you mentioned, rebound on hyperscale AI investments. Can you talk about what's driving that? Because obviously, investment in AI servers has been strong for several quarters, and maybe you guys haven't quite as participated in that as much as others in the market. So what's changing? Is it market share gains? Is it your customer, specific customers that are spending more, something related to other component availability that pulls you in? Can you just talk about that?

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.

A

Yeah. I'll be happy to. We think what happened was, our customers first had to focus on brick and mortar. They had to build the data center infrastructure. Then they had to secure the modules primarily with NVIDIA chips in them. And then they can go after power supplies and other things they need to complete the data centers. So I think, we're okay with regards to our market share in the data center. In fact, we're actually selling and differentiating based on reliability, efficiency and power density, and those three factors become much more important with artificial intelligence servers.

Reliability is extremely important because these servers are very costly compared to conventional servers. The efficiency and power density metrics are very important because these AI racks consume 3 to 5 times the power of conventional racks. So we think we're in a good position. The other thing that's helping us is our execution. So we've been able to execute on some near-term requirements from our customers and we think that's provided some differentiation in addition to our technical attributes.

Operator: And the next question comes from the line of Steve Barger with KeyBanc Capital Markets. Please proceed with your question.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

Q

Thanks. For the comment about design activity being at an all-time high, are you measuring that by starts or by dollar amount of activity or some other metric? And can you quantify where design-in is on a year-over-year basis?

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.

A

Yes, Steve. We'll be happy to give you some figures of merit. When we look at 2023, our design win funnel, the dollar value in the funnel increased 50% just for the industrial and medical part of our business. As I look to our semiconductor part of the business, our metrics are more focused on major design wins. And I talked in the opening about the progress we're making with our eVoS and eVerest platforms. The fact that we've shipped 50 of those platforms already and have demand for another 150 of those platforms before the end of this year is very significant. It means that our customers have looked at the initial units that we ship to them and they want more. And so what we're seeing is that, these units are going into not just our customers' laboratories, but also into end user wafer fabs. And so there's a race right now to be included as the process or the tool of record for the next super node, which is 2 nanometer, and also to be included in the most advanced memory processors, whether it's DRAM or NAND. So I think we're in really good shape there. And we'll see that market share increase in semiconductor based on our major design wins that we're currently working on this year.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.
Q

Yeah. That is super encouraging. Are you ready for high-volume manufacturing for eVoS and eVerest if it came to that?

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.
A

Yeah. It's a great question. So we will have two manufacturing sites for eVoS and eVerest. The one we have today is in Malaysia in Penang. And we're also in the process of building a second factory in Thailand. I mentioned that in previous calls. That'll come on line in the third quarter of next year. And the first products we're introducing there will be plasma-fired products, there'll be eVoS, eVerest in some of our high-running products. So I think we're in good shape. We'll have two very solid manufacturing sites for eVoS and eVerest. And I think the ramp could be more pronounced than normal given the strong demand we've seen this year.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.
Q

Got it. And then for my follow up or maybe really my second follow up, I know it's hard to model a trough and I don't want to parse your words too closely. But when you predicted 2Q revenue rebound, I noticed the low end of the guide is not far from 1Q, which I would just call more flat. Can you talk about the confidence in the rebound and whether you're leaning towards low, middle or high based on what you can see today?

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.
A

Well, I would say, once burned, twice shy. So I think our guidance for Q2 is relatively conservative. What we've seen basically in the data center side is a surge in orders. So we're basically working as hard as we can to fill those orders this quarter. So I think that's very secure. And for the rest of the business, we're basically modeling flat, which is pretty low to begin with.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.
Q

Understood. Thanks.

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.
A

Sure.

Operator: And the next question comes from the line of Krish Sankar with TD Cowen. Please proceed with your question.

Krish Sankar
Analyst, TD Cowen

Q

Yeah. Hi. Thanks for taking my question. Steve, I had a question on your semi revenues have been kind of bouncing on the $180 million plus or minus $10 million, $15 million range for like almost five quarters now. I understand you went through a cyclical downturn and your customers were destocking. The real question is, I'm just trying to wonder, like, I understand the cyclical rebound, but is really the true driver for semi revenue is going to come in NAND if the CapEx starts flowing through, or do you think there are other vectors within that that can help you drive semi revenues better than kind of this range we've been in?

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.

A

Yeah. Krish, I think one of the bigger drivers over the past year has been trailing edge logic. I think that's been a big part of the TAM in semiconductor equipment. So we've been fortunate to be a part of that. Obviously, the NAND demand has been low for the last 18 months. In DRAM, we've also been suffering there. So I think what we see moving forward, Krish, is in the second half we're expecting to see some mild recovery begin for DRAM manufacturing, and also for leading-edge logic. And then we expect things to accelerate in 2025, as NAND comes back on line. So that's our current outlook on the products we've been producing for years. Then we layer on top of that the demand for eVoS and eVerest for leading edge memory and logic processors. So we think 2025 is going to be a real good year for us.

Krish Sankar
Analyst, TD Cowen

Q

So Steve, I'll just take a follow up and I had one more question for Paul after that. When do you expect, Steve, lagging edge semi to rebound?

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.

A

Okay. I'll go ahead and take that question. It's very difficult to say. I think, the way we think about lagging edge is, there's China and non-China lagging edge. And I think for non-China lagging edge, things have been in a trough for a while. And it's difficult to predict when that's going to come back. So we're kind of in a wait and see mode. I think it's similar in China. The China demand, based on what we've seen from our customers, is still reasonably strong. And we'll have to see how that develops in the coming quarters.

Krish Sankar
Analyst, TD Cowen

Q

Got it. And then a quick follow up for Paul. Kind of similar question, the gross margin has been stuck in this range in the 35% plus or minus. You're talking about getting to like, 250 basis points, 300 basis points higher exiting this year. In the past, you spoke about premium pricing. There is a headwind, it's going to become a tailwind, but obviously, volume sell-through. Is the gross margin rebound predominantly volume-driven and manufacturing costs shutting down factory, or did you ever see any of its premium pricing things capture? And also, do you expect calendar 2024 exit rates for revenues to be $400 million a quarter?

Paul R. Oldham
Chief Financial Officer & Executive Vice President, Advanced Energy Industries, Inc.

A

Yeah. So good questions. On the gross margin, the first thing I'd say is, we're pretty pleased that we were able to defend the gross margins at 35% on down revenue. And I think that's a function of, we had good mix, but we're also starting to see some of the benefit of some of our manufacturing cost actions. And we think that'll sort of be in the same range in Q2 as we see revenues come back to roughly the $350 million, and the mix kind of shifts back to where it was before. But as we look towards the end of the year, the big thing I think that's changing is, first, we are starting to see the benefit of more of our manufacturing consolidation activity. It's a transition. We're moving products from one site to another, which means we have to build up on the second site before we can take products out of the first site. And so we start to see the benefits of that really come in towards the latter part of this year.

That's worth, just I say in a general basis, 100 basis points of the improvement. You're right, getting higher volume probably is another 100 basis points of that. And our model, as we mentioned last quarter is, that comes in at about $400 million of revenue. So we said, we think we're on track to the same projections we had last quarter, which means generally we see that $400 million within range by the end of the year. The last piece is the material costs. And a lot of the benefit that we've seen has already come through. As you recall, if you go back four or five quarters, that was running 300 basis points of bad news to gross margin. That's been trending down, is down into the 50 basis points or so, and we expect that to largely wash through in the next quarter. So I think the material cost in terms of the premiums is largely getting back into a normal range. We always have some fits and starts with the piece part here or there. So I think that's getting largely back to normal.

Now, it's coming down to our manufacturing cost improvements, recovery in volumes, and then over a longer period of time, our portfolio improvements. Our new products, Steve talked about, design wins we're seeing both in Industrial and Medical, and in semi with our eVoS and eVerest, all those should contribute to better margins. I'll also make one other comment, and that is, as we see the data center market recovering, as Steve mentioned, that's driven by a lot of the AI investment that really demands the capabilities that we've been focused on. As you recall, we've had a more selective strategy there to focus where customers value our differentiation and are willing to pay for that. So while margins in that part of the market aren't as strong as the others, they're much better than they used to be because of where we focused. So I think that's also helping us as we go forward as well.

Krish Sankar
Analyst, TD Cowen

Q

All right. Thank you very much, Paul. That's very helpful. Thank you.

Paul R. Oldham
Chief Financial Officer & Executive Vice President, Advanced Energy Industries, Inc.

A

You bet.

Operator: And the next question comes from the line of James Ricchiuti with Needham and Company. Please proceed with your question.

Jim Ricchiuti
Analyst, Needham & Co. LLC

Q

Hi. Thanks. Good afternoon. Hey, Paul, if we look out to the second half and see more of these markets beginning to recover, question about OpEx. What kind of OpEx will be required to support the higher revenues?

Did you see a need – it sounds like you guys are increasing R&D spend, but just in general, as we think about OpEx and the markets recovering.

Paul R. Oldham
Chief Financial Officer & Executive Vice President, Advanced Energy Industries, Inc.

A

Yeah. I think a good way to think about that, Jim, is that, we guided to $1 million to $2 million higher in Q2. I think based, as volumes pick up, we'll see some, a little bit of variable cost continue to accelerate our efforts on getting these new products qualified. So it's probably reasonable to think about a similar increase in each of the next couple of quarters. Now, I think that's lower than maybe we talked about earlier because we've taken some near-term actions to help mitigate the growth of spending, as we get all these new products and everything else out into the market. So that's probably the way to think of it, similar increase in Q3 and Q4 relative to kind of the guidance we gave in Q2.

Jim Ricchiuti
Analyst, Needham & Co. LLC

Q

Got it. Hey, Steve, I wanted to go back to some of the commentary you provided on design wins in industrial and medical markets. Can you talk a little bit about whether you may want to split the two, starting with medical first, or is the design win activity that you're seeing coming, I presume, mainly from existing customers, is that fair to say?

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.

A

Yeah, Jim, I'll start with medical. I think you're correct. When we purchased SL Power a couple of years ago, they had a set of medical customers, they complemented our set of medical customers. So what we've been doing for the past two years is cross-pollinating the products between these two sets of customers. And I think medical has got a relatively well-defined set of big customers, and then a lot of smaller customers that go through distribution. So yes, most of the big design wins are coming through established customers that either SL Power brought to Advanced Energy or Advanced Energy brought to SL Power. As I look at industrial...

Jim Ricchiuti
Analyst, Needham & Co. LLC

Q

You look to make up in industrial. Yeah.

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.

A

Yeah. So industrial is a little bit different, because it's a very, very broad set of customers. So what we've done there, we've done a number of things differently over the past, let's say, year, year-and-a-half. The first is, we dedicated roughly half our sales force around the world to selling only industrial and medical products to industrial and medical customers. So this has really been a big factor behind the increase in the design win funnel. The second is, we developed a new website which makes it much easier for customers to specify the right products from Advanced Energy and to receive products very quickly from us. So I think, we're much friendlier company to do business with if you're an industrial or medical customer.

The third thing we've done is, we've increased the size of our quick-turn engineering team. What this team does is, they take our standard products and based on customer request, they will customize or tailor those products to the specific application. And so we've seen roughly a 50% increase in those spin-offs from standard products, and we could do those custom products very quickly, typically between, four and eight weeks is the development time.

And so all this activity is leading to a higher market share in industrial and medical, and a lot of optimism as we look forward about our ability to become a much more significant player in industrial and medical.

Jim Ricchiuti
Analyst, Needham & Co. LLC

Q

Got it. Helpful color. And last question, if I may, and this is a broad question just on semi. So where you sit today, would you say you're more or less optimistic about the improvement in the second half versus, say, three months ago?

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.

A

I'd say, it's about the same. I think the forecast that we have today support a high single-digit percentage, perhaps 10% increase in revenue in semiconductor, first half to second half. So I think that's about the same that we saw a quarter ago. So really, nothing has changed when it comes to the second half of this year. I think what's changed for us is really our view of next year, and that's based on our success with eVoS and eVerest, our first design wins and the intensity of activity we're seeing at our customers right now.

Jim Ricchiuti
Analyst, Needham & Co. LLC

Q

Got it. Thanks very much.

Operator: And the next question comes from the line of Scott Graham with Seaport Research. Please proceed with your question.

Scott Graham
Analyst, Seaport Global Securities LLC

Q

Hey. Good afternoon. Thanks for taking my question. And Steve, you sound better than you did a quarter ago. I know that the revenue print was a little hard, but the gross margin held up well, and you sound better on the outlook. I wanted to ask you a question about the data center business, because I cover a number of companies as others do that have a lot of data center exposure, and not really seeing the declines that you guys have been seeing the last couple of quarters, in fact, in most cases, to the contrary. I know you kind of walked us through that, you kind of think that the power conversion equipment goes in, let's say, last. Would you color that, the last couple quarters of declines? That way, was there perhaps some destocking involved there, or was it something else, because you sound obviously and for August order's sake, much more optimistic about data centers going forward. I just want to try to understand what happened on the look back.

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.

A

Yeah. Scott, I think part of it was just the sequential procurement strategy where you can't build these AI-enabled data centers without a commitment of chips and modules for the GPU and the high bandwidth memory. So I think once our customers were able to secure those allocations, then they were able to come to companies like Advanced Energy and purchase advanced power supplies. So I think that's part of it. I think, second part of, as I look back over the last three or four quarters is, first, this is a cyclical market.

If you look back over the last 10 years, this is the way it goes. They tend to buy a lot and then they go into an inventory digestion mode and they come roaring back and it's pretty much on schedule. So we would expect to see strong demand from data center for the next four to five quarters based on the last two cycles we went through. I think the third factor is, these customers were also impacted by the supply chain issues over the past few years, and I'm sure there were some inventory issues that they were dealing with as well.

Scott Graham
Analyst, Seaport Global Securities LLC
Q

Fair enough. Thank you for that. I just wanted to maybe touch on the balance sheet, the liquidity there. You did a debt deal couple of quarters back. And is it essentially that industrial and medical are just sort of sluggish markets for you right now that you're not looking there, or what is the outlook for the announcement of the closing of a deal or more this year? How does that pipe looking? What's your optimism on timing of closing?

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.
A

Yes. So maybe I'll chime in here. I think we're fortunate, and that we generated cash as a company and that we had a successful convertible deal in September. So we're sitting on over $1 billion in cash. That said, we're not going to do a deal. It doesn't make sense for the company. And so we're still looking for a deal that makes financial sense for the company, make strategic sense for the company that we could integrate quickly, and it averages up our gross margin. So we're still working on it, and we'll see what develops in the coming months.

Scott Graham
Analyst, Seaport Global Securities LLC
Q

I guess, more to the point, my question is, is your deal pipeline a little thicker than it was six months ago, and is your optimism higher or is that weakness in those businesses may be a bit of a barrier?

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.
A

Well, I think the deal pipeline may be slightly thicker. We've always had a good pipeline. And our practice has been to develop relationships with our potential target companies so that we're there, first in line when they decide it's time to make a move. That said, I think there's always going to be issues on valuation. And so I think that's really where most of these discussions end up. You have to figure out what's a fair value for both parties.

Scott Graham
Analyst, Seaport Global Securities LLC
Q

All right. Thank you.

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.
A

Yeah.

Operator: [Operator Instructions] Our next question comes from the line of Mark Miller with Benchmark. Please proceed with your question.

Mark Miller
Analyst, The Benchmark Co. LLC
Q

You indicated that the booking trends were positive during the quarter. I was just wondering if you could break that out a bit more strongly. What were your strongest areas for bookings?

Paul R. Oldham
Chief Financial Officer & Executive Vice President, Advanced Energy Industries, Inc.

A

Yeah. Mark, it's interesting because we typically – I've talked about backlog when it expanded and now it's come down and bookings only represents part of our business. But we do think it's sort of one of those indicators that gives us confidence that things are starting to come back. And we saw increased bookings, frankly, across all of our markets, with the exception of telecom and networking. And as Steve mentioned, I think that market is particularly challenged right now, given both having inventory as well as quite a bit soft market conditions. And that's pretty well publicized.

Mark Miller
Analyst, The Benchmark Co. LLC

Q

Just wondering, in terms of your current backlog, is it a front end, back end, more linear type backlog in terms of how it flows through in terms of sales. And what about the margin profiles, is it similar or improving in terms of what you've recently been seeing?

Paul R. Oldham
Chief Financial Officer & Executive Vice President, Advanced Energy Industries, Inc.

A

Yeah. I think the margin profile is similar, maybe improving a bit, mainly because of the comments I made earlier about the strength of our portfolio. I think the second part of that is, I think the characterization is still the same. If you recognize, our lead times now have come down to more normalized levels of 8 to 12 weeks. So the backlog is pretty, I'll say, front-loaded. But particularly, as Steve mentioned in medical, we're seeing backlog filling in for the second half of the year, which gives us more confidence, again, that at least that part of the market is maybe starting to work through their inventory issues.

Mark Miller
Analyst, The Benchmark Co. LLC

Q

Thank you.

Operator: And the next question is a follow up from Krish Sankar with TD Cowen. Please proceed with your question.

Krish Sankar
Analyst, TD Cowen

Q

Yeah. I had a few quick questions. One is, Steve, on the hyperscaler opportunity, I remember a few years ago when after you took over there was a renewed focus on I&M, I don't want to use the term defocused, but less of a focus on hyperscalers. But clearly, with AI and everything, there's a renewed focus on power management for AI. So just curious, given the fact that compared to some of your peers, like one of the questioners asked, you're kind of lagging on that. Do you think any of that defocus in the last few years is hurting you now? Because in the past, I understand hyperscalers, they're very price sensitive, and it's like, not an extremely winning game for you. But do you think that defocus has kind of been an issue, or do you think at the end of the day it's really about the product quality that matters for AI servers from a hyperscaler standpoint?

Stephen Douglas Kelley
President, Chief Executive Officer & Director, Advanced Energy Industries, Inc.

A

Yeah. Good question, Krish. Let me just recap. The decisions we made a few years ago were to invest heavily in semiconductor, industrial, medical and grow market share as fast as we could, because all of those products basically averages up from a gross margin standpoint. So on the data center side, we have a different strategy and we articulated that a few years ago and we've executed on it, and that is, we want to improve the bottom line of that business and then keep it there. So the good news is, we improved the bottom line over the past two years in data center, and now we're in the process of keeping that type of gross margin performance.

It's still not above corporate average and probably never will be. But we're much happier with the business today because we can deal with a surge like we're seeing this quarter without impacting our gross margin performance to any significant degree. So we're very happy with the business. And part of that move two years ago was to start focusing our engineering teams on more differentiated opportunities. And so what we're seeing now is some of those differentiated opportunities are developing into large scale revenue opportunities for us, which is very helpful. So less of a commodity focus and more of a differentiated focus. And I think it's paying off for us.

Krish Sankar
Analyst, TD Cowen

Q

Got it. And then just a quick, another follow up for Paul. I know you didn't give the backlog number, but it looks like it's falling to $350 million to $400 million range. How much of that is semi?

Paul R. Oldham
Chief Financial Officer & Executive Vice President, Advanced Energy Industries, Inc.

A

Yeah. I'd say, it's down slightly from last quarter, so maybe a little higher than that, Krish. I would say, the semi proportion is about the same as it's been, and we've commented before that semi and industrial and medical combined represent about 80% of the backlog. So I don't think those proportions have changed very much.

Krish Sankar
Analyst, TD Cowen

Q

Got it. All right. Awesome. Thank you very much.

Operator: And our next question is a follow up from Mark Miller with Benchmark. Please proceed with your question.

Mark Miller
Analyst, The Benchmark Co. LLC

Q

I'm just wondering, your interest income had a nice increase. Could you describe what's going on there?

Paul R. Oldham
Chief Financial Officer & Executive Vice President, Advanced Energy Industries, Inc.

A

Yeah. As you know, Mark, we did raise money from the convert last fall. The good news about that is, we raised money at 2.5% coupon. And we've been able to do two things; one, we've been able to concentrate our cash globally quite effectively, so that we get that cash in the places, in accounts where we can invest it. And we've been quite successful at investing that at very good yields on money market, very short-term notes. And so we're actually generating more interest income than interest expense right now. Now, we're also benefited from the fact that about two-thirds of our term loan is still under a swap agreement wherein we're only paying 1.25% interest. And that will come off for that amount in September. So I think you'll see interest income and interest expense start to come a little more in balance, but we'll still have higher income than expense, but lower than we have today.

Mark Miller
Analyst, The Benchmark Co. LLC

Q

Okay. So you expect somewhat lower interest expense in the second quarter.

Paul R. Oldham
Chief Financial Officer & Executive Vice President, Advanced Energy Industries, Inc.

A

More like the second half. This happens in September. Otherwise, second quarter, outlook very similar to first quarter when you look at total other income.

Mark Miller
Analyst, The Benchmark Co. LLC

Q

Okay. But lower in the second half. Okay. Thank you.

Paul R. Oldham
Chief Financial Officer & Executive Vice President, Advanced Energy Industries, Inc.

A

That's right.

Operator: And ladies and gentlemen, at this time, there are no further questions. And that concludes the question-and-answer session and that also concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.