01-Nov-2022

Advanced Energy Industries, Inc. (AEIS)

Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings. Welcome to the Advanced Energy Third Quarter 2022 Earnings Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] Please note this conference is being recorded.

I will now turn the conference over to your host, Edwin Mok, Vice President of Strategic Marketing and Investor Relations. You may begin.

Y. Edwin Mok

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

Thank you, operator. Good afternoon, everyone. Welcome to Advanced Energy third quarter 2022 earnings conference call. With me today are Steve Kelley, our President and CEO; and Paul Oldham, our Executive Vice President and CFO.

Before I begin, I'd like to mention that we will be participating at several investor conferences in the coming months. If you have not seen our earnings press release and presentation, you can find them on our website at ir.advancedenergy.com.

Let 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, November 1, 2022, and the company assumes no obligation to update them. Medium-term targets and long-term aspirational goals 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. Exclude from our non-GAAP results are stock compensation, amortization, acquisition-related costs, restructuring expenses, unrealized foreign exchange gains and gains from a one-time sales of our non-strategic technology. 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. Our third quarter was one for the record books, with over $500 million revenue and more than $2 of earnings per share. In addition, we delivered strong cash flow. This outperformance was largely a function of improved component supply, our part qualification and redesign efforts and good manufacturing execution.

Demand for our products remains strong. Two-thirds of our nearly $1.1 billion backlog is shippable in the next two quarters. That gives us opportunity for upside should our critical component suppliers improve upon their current delivery commitments.

In the near term, our tactical focus will be on operational execution, particularly the sourcing of critical components and the quick conversion of those components into product revenue. Strategically, we are focused on accelerating new product and technology development with the ultimate goal of achieving undisputed technology leadership in each of our target markets.

Now, I'll provide some further color on the current supply environment. While we have started to see some improvements, the environment remains dynamic. Deliveries of critical ICs, which are largely produced on older process nodes, are still the biggest source of uncertainty in our production planning process.

We continue to pay significant premiums for critical ICs and appreciate the continued support of our customers in helping to absorb some of those incremental costs. Our strategic decisions to maintain surge capacity and to aggressively mitigate parts shortages have allowed us to quickly convert lumpy deliveries of scarce components into revenue. This in turn has enabled much improved financial performance in 2022.

Now, I'd like to provide some additional color on market demand. Currently, demand exceeds supply in many areas of our business. Solid end-market demand, coupled with a need to replenish channel inventories and safety stocks, are the key factors driving our fourth quarter revenue forecast. We do recognize, however, that the macro environment is changing and that end-market demand will be choppier in 2023.

In the semiconductor market, we are working closely with our customers to adapt to changing market conditions, such as the recent tightening of US export controls. We have taken the necessary steps to ensure full compliance with the rules and have ceased shipments and support as required. We derive only a small percentage of our revenue from Chinese-owned semiconductor companies. However, many of our non-Chinese customers have been impacted by the new regulations and are currently reassessing their build plans.

Based on current market trends and the new export controls, we expect that semiconductor and market demand will decline in 2023. Over the coming weeks, we plan to work closely with our customers to fine-tune our medium-term demand forecast.

Moving to our other markets, which now account for nearly half of our revenue, the industrial, medical, computing, telecom and networking market are important sources of profitability and growth for Advanced Energy. They provide balance to our product portfolio and should enable us to maintain good profitability and cash flow even through a dip in semiconductor demand. We also expect that our service business, which generated $45 million of revenue in the third quarter, will continue to grow at a steady pace. The installed base of Advanced Energy subsystems has grown significantly and we now offer a much wider selection of value-added services. Finally, we are encouraged by an accelerating rate of design wins across our portfolio, which we believe will drive further share gains in 2023.

Now, I'll provide more color for each of our target markets. In semiconductor, revenues were up over 50% year-on-year to $267 million, a new record for the company. And we expected fourth quarter revenues, although down sequentially, will be up more than 30% year-on-year. For the full year 2022, we expect semiconductor revenue growth of more than 30%.

On the product development front, we are making good progress. Ongoing customer evaluations of our new products and technologies for conductor etch, dielectric etch, and remote plasma source applications are going well.

In the quarter, we secured a key metal deposition design win for advanced logic applications. In the industrial and medical markets, third quarter revenue grew nearly 50% year-on-year to $120 million, a new record for the company. Demand remains strong, as reflected in our backlog, which remained roughly flat despite our overperformance in the third quarter.

Within industrial and medical, we play in a wide range of specialized applications, many of which are benefiting from long-term secular growth drivers, such as Industry 4.0, electrification, indoor farming, and healthcare. While the industrial medical markets as a whole had been historically sensitive to macroeconomic conditions, we believe that our strong design win pipeline, coupled with increased market reach, will enable us to outgrow the overall market in the coming year.

Medical is an important market for us, particularly after the acquisition of SL Power. We now offer a comprehensive suite of medical power products and that substantially increased our engagements with Tier 1 medical equipment OEMs. This quarter in the medical market, we won key positions in surgical equipment and life science applications.

In the industrial market, we notched significant wins in electric vehicle charging in test and measurement applications. In the data center, telecom and networking markets, we outstripped our forecast in the third quarter, largely due to better parts availability. During the quarter, we won several high-value designs, which will help to drive long-term profitable revenue growth. Overall, we performed exceptionally well in the third quarter and are forecasting a strong fourth quarter performance. Looking forward, we believe that our strong design win pipeline, solid order book, low channel inventory and balanced market exposure will enable us to outperform our markets in 2023.

In closing, I'd like to highlight our focus areas moving into next year. First, we will accelerate revenue growth by bringing innovative products and technologies to our customers. Second, we will optimize our manufacturing footprint. Seeking to maximize our efficiency, flexibility and quality. And finally, given our strong balance sheet, we will continue to look for M&A opportunities, which make strategic and financial sense for the company.

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

Paul R. Oldham

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

Thank you, Steve. Good afternoon, everyone. In the third quarter, we delivered extraordinary results across a range of financial metrics, demonstrating some of the pent-up earnings potential in the company. Increased supply of critical components, combined with the ability of our operations team to respond quickly, enabled us to deliver revenue of $516 million and EPS of $2.12 per share, both well above our guidance ranges. Backlog declined slightly to approximately $1.1 billion on much higher revenue, reflecting continued solid demand for our products. We continue to believe our backlog position and multiple AE-specific drivers should enable Advanced Energy to relatively outperform as our markets evolve over the next several quarters.

Now, let me go over our financial results. Third quarter revenue was a record $516 million, growing 49% year-over-year and 17% sequentially. Revenue in the semiconductor market grew 54% from last year and 17% sequentially to $267 million. Improved supply and great operational execution allowed us to deliver upside in the quarter and achieve record revenue levels.

Revenue in the industrial and medical market also reached a record $120 million, growing 48% from last year and 14% from the second quarter. Excluding SL Power, organic growth was 29% year-over-year and 12% sequentially, driven by strong market demand and improved supply of critical ICs.

Improved supply also allowed us to grow data center computing revenue 41% year-over-year and 27% sequentially to $88 million, on par with 2020's record levels. Telecom and networking revenue was $43 million, up 40% from last year and 12% from the second quarter.

Third quarter gross margin was 37.5%, up 40 basis points from last quarter, due primarily to higher factory output, largely offset by continued premiums paid for scarce parts and unfavorable mix. Higher material costs and partial recoveries from our customers continue to run at peak levels, impacting gross margins overall by approximately 300 basis points in the quarter, of which premium recoveries accounted for about half of the impact. Although we see potential for improvement, we expect the higher material costs and related premium recoveries will continue to negatively impact our results in the fourth quarter and into the first half of 2023, given the timing of inventory sell-through. However, we expect these higher costs will gradually come down over the course of 2023 based on our mitigating actions and normalization of the supply chain.

Operating expenses were $99.8 million, up approximately 6% from last quarter, mainly due to a full quarter vessel power and higher variable costs on strong revenue. Operating margin for the quarter was 18.1%. Depreciation for the quarter was $8.5 million, and our adjusted EBITDA was a record $102 million, up from $78 million last quarter.

Our GAAP other income this quarter was $8.9 million due to $6.2 million of unrealized foreign exchange gains and a one-time $4.7 million gain on the sale of nonstrategic technology from a prior acquisition. Non-GAAP other expense was $1.9 million, including $2 million of interest expense and $300,000 of foreign exchange losses, partially offset by interest income and other items. Due to the increased interest rate environment, we expect non-GAAP other expense to trend a little higher and to be in the $2 million to $2.5 million range going forward. Third quarter earnings were a record $2.12 per share, up from second quarter EPS of $1.44 and last year's $0.89.

Turning now to the balance sheet, we ended the third quarter with total cash, including marketable securities of $411 million and net cash of $33 million. Cash flow from continuing operations was a robust $65 million due to our strong financial performance. Inventory turns improved from 2.8 times last quarter to 3.2 times this quarter primarily on higher revenues. DSO improved modestly to 54 days and DPO declined slightly to 61 days. As a result, net working capital improved to 106 days.

During the third quarter, we invested $14 million in CapEx, made debt principal payments of $5 million and paid $3.8 million in dividends. In addition, we repurchased $2.4 million worth of common stock at $69.39 per share as part of our opportunistic share repurchase program.

Now, let me turn to guidance. Demand in many of our markets remain higher than supply. As we continue to reduce shortages of critical parts and improve our lead times, we expect to bring our backlog to more normalized levels over the next several quarters. Given the strong performance in the third quarter, continued parts constraints and the initial impact of headwinds in the semiconductor market, we expect revenues for the fourth quarter to be approximately $470 million, plus or minus $20 million. The midpoint of our Q4 guidance reflects 18% year-over-year growth and would be the second highest quarterly revenue ever for Advanced Energy.

Our Q4 guidance assumes semiconductor revenue will decline sequentially, but increase by over 30% from last year. Revenues in our other markets will be gated based on supply of components. We expect Q4 gross margin to be in the 37% range on continued high material cost premiums. We expect operating expenses to be up slightly on timing of programs and specific investments. Based on our tax rate of 18% to 19%, we expect Q4 non-GAAP earnings per share to be $1.55, plus or minus $0.25, ahead of our target set earlier in the year for our fourth quarter exit rate.

Before I pass the call to the operator, I want to make a few important points. The outstanding financial performance in the third quarter illustrates the substantial earnings potential in our model as we are able to procure critical parts. Looking forward, we believe our large order book, multiple growth drivers and balanced market exposure can support revenues at a higher run rate than historical levels during times of market cyclicality.

In addition, improvements in the supply chain combined with a focus on optimizing our manufacturing operations should allow us to lower material costs and improve efficiencies to achieve our target of 40% gross margin over time. Long term, we believe demand for our proprietary products will continue to grow as our strategic programs start to deliver results. And strong cash flow generation and liquidity will allow us to continue to pursue strategic investments to expand our position in our target markets. Overall, these factors should enable Advanced Energy to outperform our markets in 2023 and over time.

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

QUESTION AND ANSWER SECTION

Operator: And at this time, we will be conducting a question-and-answer session. [Operator Instructions] Our first question comes from the line of Quinn Bolton with Needham & Company. Please proceed with your question.

Quinn Bolton
Analyst, Needham & Co. LLC

Q

Hey, guys. Congratulations on the nice results. I guess a couple of questions looking into next year. Obviously, the WFE environment is changing and I think some of the big OEMs in this sector have talked about WFE down 20%. So, my first question is, given your backlog position, the need for restocking, do you think you guys would do better than a down 20% WFE environment within the semiconductor business?

And my second question is how do you see demand in the industrial, medical, telecom and server? Are those businesses – are you seeing demand hold up better in those end markets? Are you starting to see some signs that orders in those markets are also beginning to trend lower? Thank you.

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

A

Okay. Quinn, I'll take those. This is Steve. I think looking at 2023, without providing guidance, we definitely see 2023 as being down over 2022 when it comes to the semiconductor equipment demand. That's clear with the new export control regulations and the memory market correction and the softening in the advanced logic market that there are some issues there. But as I look forward, I also see some factors that are probably working in our favor.

First of all, we usually work with our largest customers with just-in-time inventory bins and those bins largely need to be refilled. So that's somewhat of a cushioner as we move into the next year. With our other customers in semiconductor, our non-JIT customers, most of those customers have moved to a just-in-case approach. And so, they want to put in safety stock. And again, that's going to help us.

Another key factor for us is our service business. Service, as I mentioned in the script, it was a $45 million business for us last quarter. So, that's grown quite a bit over the past few years, largely because our installed base has grown. And also, we offer a lot more value-added services.

Maybe talking about the semiconductor market in general, I view it in three basic categories. There's memory market, there's the leading edge logic market. And then, there's the trailing edge market.

In the memory market, obviously, goes through cycles connected to supplier investment and then consumer demand. And I think we're going through the latest cycle essentially. I think the big factor that people may not fully appreciate is the size of the trailing edge market. That market continues to be oversold. As reflected in the fact, we're still chasing parts. That's I think the – one of the largest pieces of the pie when it comes to semiconductors. So, I think that market is going to be strong throughout 2023. And the other two markets will come back probably in the second half of next year. So, that's what I see as for semiconductors.

Now, looking at the other markets, industrial, medical, telecom, the networking and data center, and so forth. Right now, we don't see signs of softening there. In fact, we are still capping a number of parts shortages in those areas. So, we think shortages on those areas. So we think there's a lot of upside there as our suppliers are able to improve their commitments. We have a lot of current backlog that gets shipped over the next two quarters.

The other key point with the rest of our business is we play in a wide variety of markets and they operate in different cycles. So where one market maybe down and other is up, and overall, I think it's a much more stable environment than semiconductor.

Quinn Bolton
Analyst, Needham & Co. LLC

Q

Got it. And just a quick follow-up for Paul. If I think about 2023, you mentioned the 300 basis points impact on higher material costs, including components, and some of that goes away as you get into next year. But it looks like your product mix probably becomes a headwind as semiconductor revenue probably going to decline more than the other end markets. And so, from the 37% sort of level, how should we think about margins as they trend through next year? Do you think the recovery of component costs more than offsets product mix? Do you think they're about offsetting factors? I mean, any thoughts as you think about gross margins next year would be helpful.

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

A

That's a good question, Quinn. First, as we talked about the scarce component environment continues, and this last quarter was actually our highest quarter ever for premiums that we paid, as well as premiums we recovered. But the point is we kind of thought earlier that might – got be starting to subside and we haven't seen it yet. But that means is this impact of premium costs is going to continue certainly through the fourth quarter and into probably the first half of next year, because remember, it will take us about a quarter or so for the full cost to roll through the P&L, even after the input costs start to come down.

So, I think we're going to probably stay in this range for at least another couple of quarters. And then, as those material costs subside, there's no reason we shouldn't pick up the vast majority of that 300 basis point recover, I'll say, over time. So I think it's going to be a slower progression to see margins recover over the course of next year and I do think the material recovery will outweigh any shift in the mix that we see.

Quinn Bolton
Analyst, Needham & Co. LLC

Q

Perfect. Thank you, Paul. Thank you, Steve.

Operator: Our next question comes from the line of Scott Graham with Loop Capital Markets. Please proceed with your question.

Scott Graham
Analyst, Loop Capital Markets LLC

Q

Yes. Hey. Good afternoon. Thank you for taking my question and terrific quarter. Congratulations. Can you hear me?

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

A

We can hear you. Yes, loud and clear.

Scott Graham
Analyst, Loop Capital Markets LLC

Q

Okay. Okay. Great. Great. So, I'm wondering, as we head into next year, I think we all appreciate your views on WFE. So your trailing edge logic market being oversold is very interesting observation. It seems, however, that the memory side is weakening by the moment. And with some of the big memory makers, down 50 and some of them are actually saying that just – that it might move out later into the year as well and maybe sort of less than the first quarter, maybe more in the second and third, depending upon who you speak with.

I'm just wondering could you give us an idea of how you guys are – your semiconductor businesses is exposed? I assume that you're tilted toward memory versus foundry and logic. Could you help us understand your business itself?

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

A

Yeah. I could talk in general about that. I think our business is more tilted towards foundry logic because the intensity of conductor etch equipment is higher in the logic side than it is in memory side. So we will certainly feel the memory slowdown. But we have to remember memory is about, I think, roughly 35% to 40% of the total market today from a WFE standpoint. And so we're less exposed there than we are to the other part of the market, which is logic, both leading edge and trailing edge logic together.

What we see in memory is continued investment because they still need to invest for the next generation, right? They need to drive higher yields, more complex structures. And we're participating with those customers today to move to the next generation. So even though they may be pausing some of the capacity expansion, they're moving full speed ahead on new product development and new process development. So it's a great opportunity for us to get some new technology into those customers.

Scott Graham
Analyst, Loop Capital Markets LLC

Q

Okay. Thank you. I guess my next question sort of an extension of that one is you have an extremely high backlog. And I'm just wondering what those shipment schedules look like. I assume that they are not firm delivery dates and the customers could push them back. Could you give us a little bit of flavor for maybe what the backlog sort of shipment schedule looks like? And then how firm is – are those dates?

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

A

Yeah. It's a good question, Scott. Look, we've seen our backlog be pretty consistent that the demand is close in. In fact, we've said and continue to see that our backlog from a customer request date, it's either – they either want it now or it's – they would like it within the next two quarters, so approximately five months, two-thirds of it. So it's current backlog. It's not backlog that's scheduled out over a long period of time that could be subject to change.

Now, as a practical matter, our customers can certainly reschedule backlog, but to date, we've seen more expedites and people continuing to ask for backlog than reschedule. So we feel like it's still very good quality backlog. And it's going to take us a few quarters to actually work that down to a more normalized level. As Steve said, in many of our markets, the demand continues to exceed the supply.

Scott Graham
Analyst, Loop Capital Markets LLC

Q

I appreciate that. Thank you both.

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

Krish Sankar
Analyst, Cowen & Co. LLC

Q

Yeah. Hi. Thanks for taking my question. I actually had a few of them. First one, just out of curiosity, on the $1.1 billion in backlog, how much of that is semis?

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

A

We've said that the combination of semi and industrial and medical represents about 80% of the total. So we haven't broken it out specifically, but it's in the ballpark of 50/50.

Krish Sankar
Analyst, Cowen & Co. LLC

Q

Got it. Got it. Fair enough. [Technical Difficulty] (31:06) in the past, downturn is clearly, if you look at this year that outgoing WFE is an upcycle. And typically in down cycle, we actually underperform WFE. So I'm kind of curious why wouldn't that be the case next year if you just assume that it's a normal cyclical downturn, your customers are going to end up using up your inventory versus purchasing from you, so why would [ph] they behave (31:33) be different this time around?

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

A

Yeah. I think the biggest difference is just a lack of inventory out there, Krish. So, as we look into our direct customers and into their customers, there's very little inventory of our critical subsystems out there. So, first of all, they're still pulling for immediate needs – installation needs. And second of all, they're going to pull from us to refill some of those jet bins that have been depleted over the past year and a half. So, I think it's a different type of correction for us. And I think if you combine that with some transitions that are occurring as people move to new technologies, we have a very good position there. And that also serves to counteract some of the down part of the cycle.

Krish Sankar
Analyst, Cowen & Co. LLC

Q

Got it. Got it. All right. And then, just a final question for Paul. Can you just help us quantify what are the impacts from the pass-through cost and gross margin this year? And if that thing normalizes next year or into the next few quarters, but your revenue decels, is it fair to assume the negative leverage because of revenue deceleration would overwhelm any kind of tailwind you get from some of these supply costs easing?

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

A

Yeah. It's a good question. I guess, we quantified the impact of both the premium recoveries, which is essentially revenue that we're getting, that's a zero margin, that's about 150 basis this quarter. And if you go back over our last two or three conference calls, it's kind of been in the 150 basis point to 180 basis point range. You can do the math on that, Krish. But that's essentially calorie-free revenue, which means that revenue we would expect to go down, but gross margin wouldn't change. That's going to make our model look better and that will be a headwind to revenue next year, but won't change gross margins.

In addition to that, we have about an equal amount of premiums that we're paying that we're not getting any recovery for. Those should also go away. That's not normal pricing from the supplier. That's premiums we're paying to brokers or other third parties to get the parts wherever we can. That will be real improvement to gross margin that will not only improve our model, but improve earnings.

And so, it's going to be some trade-off. Clearly, there's some – there will be negative leverage from lower revenue. Some of that comes for free and some of it will impact our margins. But I think the better way to think about it is we should get that entire effectively 300 basis points back at some point in time as the supply chain normalizes, but we've also said there's 50 basis points to 100 basis points of factory inefficiencies in our model. I think it's fair to say, with the higher volumes this quarter, we probably got an equal amount of leverage this quarter.

So, it's kind of offsetting the inefficiencies, the higher volumes. So I think what you'll see is maybe we don't get as much back on the efficiencies that we would expect that 50 basis points to 100 basis points because of the negative leverage. And that's maybe the way to think of it.

Krish Sankar
Analyst, Cowen & Co. LLC

Q

Got it. Super helpful, Paul. If I could just squeeze in one more thing, if I heard you right on I&M revenues ex-SL Power, was SL Power about $7 million in the quarter?

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

A

No. It is much higher than that. I think the number is about $17 million.

Krish Sankar
Analyst, Cowen & Co. LLC

Q

$17 million. Got it. Thank you very much. Got it. Thank you.

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

A

Yes.

Operator: Our next question comes from the line of Mehdi Hosseini with SIG. Please proceed with your...

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Yeah.. Thanks for taking my question. Paul, you said OpEx should be up, did you mean to imply like $1 million to $2 million range?

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

A

Yeah. It's up nominally.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Okay. Right. Right. Okay.

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

A

Go ahead, Mehdi.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Okay. So, like it seems that [Technical Difficulty] (36:06-36:12) pickup in semi business in the latter part of the 2023?

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

A

Yeah. I think what you'll see is it'll be flat, maybe even down a little bit at the beginning as we focus on some efficiencies and whatnot. But as we go across the year, we'll continue to battle inflation, which we continue to see on the horizon. And we intend to continue to invest, particularly in our critical engineering programs and in strategies that will drive growth.

So, next year, obviously, with the softer market, we'll be focusing on where we can improve productivity, ensure we're delivering synergies and improve efficiency. And so, I would expect to see spending flat to up, but not up much.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Got you. And then, one question for Steve. Given the current valuation in the public market, how are you thinking about potential acquisition targets? Is there any area in semis, data centers, telecom, industrial that you offer better value or are you just focused on a strategic fit or is that combination of the two? Any color would be great as we try to better understand how you're thinking about M&A strategy.

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

A

I think in general, I think, 2023 is going to be a favorable environment for us in M&A. With high interest rates and a calmer market, I think that favors strategic buyers like Advanced Energy and allows us to pay reasonable prices for quality assets.

Our strategy is the same. We're still looking for power companies in the semiconductor, industrial and medical markets. We like companies with a high portion of sole source products. We like companies that operate in the market for a while and have a good base of customers and have a strong engineering mindset. So, that dovetails nicely with Advanced Energy.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

I think I was looking for something more specific. Is there any end-market that offers you a better value or opportunities equally distributed in four different markets?

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

A

I think that what we like about semiconductor, industrial and medical is the ability to create customized product for our customers. So, a very, very high percentage of products we ship in those markets are sole source and they're long life cycle and they're sticky. And we think that is our primary business. We're kind of in a high-mix, low-volume business, but these design wins turn into 15-year annuities, essentially.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Got it. Thank you.

Operator: Our next question comes from the line of Hans Chung with D.A. Davidson. Please proceed with your question.

Hans Chung
Analyst, D. A. Davidson & Co.

Q

Hi. Thank you for taking my question. Congratulation on a strong result. So, first question, I want to follow-up on the margin. So, I remember you talked about redesigning [indiscernible] (39:39) and that could help to mitigate the supply chain constraint, right, either for the availability of component or the costs that you pay. So just wonder how is that playing out so far. I think that is not helping a lot just based on your commentary around the impact from the cost premium. I just want to know what's the progress now, and then how should we think about that being a tailwind go into next year.

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

A

Yeah. Let me just clarify what Paul mentioned earlier. And the bottom line is the effect of the product surge has continued to shave about 300 basis points off our gross margin percentage. So, instead of 40%, we're operating 37% roughly. Now, our redesigns and alternative FERC qualifications are a different matter. They've allowed us to actually drive much higher revenues this year than last year, but we're still incurring significant costs for these scarce parts. And the list of scarce parts is shorter than it was a year ago. But all it takes is one missing part. We can't build the – we can't build the box.

So, as we move into 2023, there's two primary factors going to drive higher gross margin. First is the dissipation of these extraordinary what we call piece part variance charges. The second is continuing improvement in our product mix. So, all of our efforts in the past year and a half have been focused on sole source products in all of our markets. And we think this will drive a better mix moving forward so that we can operate above 40% gross margin in good times and bad. That's our basic financial objective as a company.

Hans Chung
Analyst, D. A. Davidson & Co.

Q

Got it. Okay. And then – so what about the operating leverage? On the OpEx side, I'd say going to 2023, as we see that decline in semi business, and how should we think about the model – the OpEx model to – during a downturn.

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

Yeah. I think as I mentioned earlier, this is the first quarter we've had a full quarter of SL Power and we were right just under $100 million. And I think we'll be up very modestly in the fourth quarter. We will do some things to help moderate those costs. But we're also fighting inflation and we're going to continue to invest in our strategic markets. So, generally, you should think about operating expense as you go into next quarter as flight – flat to up from the current run rate.

Hans Chung
Analyst, D. A. Davidson & Co.
Q

Got it. Okay. And then, on the industrial market, I think they're seeing some [indiscernible] (42:40) pockets of softness, I mean, just overall in the industry. I'm just wondering if you see any signs of weakening trends or changes in customer behavior, maybe in different sectors across the market.

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

Yeah, we haven't seen that. In fact, we're seeing the backlog stay very strong. And even though we out ship by a significant margin, our forecast in I&M last quarter, in Q3, our backlog was roughly flat. So that means we have new orders coming in to replace all of the shipments we're making. So that's a – I think that's impressive. What we're seeing is that in the markets we operate in, like test and measurement, horticulture, and other specialized markets, the demand is strong, and much of it is pent-up demand. We have under-shipped those markets for the past year. And so we're still playing catch up. And we're going to be playing catch here for the next couple of quarters in those markets.

But I think in general, we see industrial and medical as very strong areas for us moving into 2023. And we think we can grow faster than the market, not only just based on our shipment improvements, but also based on our design win pipeline, which is much stronger than it's been in quite some time because we refocus as a company about a year ago on the industrial and medical markets, and the sales team has done a great job winning a lot of new designs.

Hans Chung
Analyst, D. A. Davidson & Co.
Q

Got it. Thank you.

Operator: Our 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. Going back to the backlog, you said you don't have a lot of direct exposure to Chinese-owned companies. But do you have an estimate for what percentage of the backlog could be affected by restrictions on US customers?

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

A

Yeah. If you look at the backlog overall, it's probably in the mid-to-high single digits that would be currently allocated to those direct customers. So we'll see how that works out as we get more clarity about what can and can't be shipped. But if that all things else equal, you could think about our backlog around $1 billion ex any Chinese exposure.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

Q

Got it. And if I look at 3Q revenue and the midpoint of the 4Q guide, the averages are almost $500 million per quarter. You have, as you noted, $700 million of shippable backlog if you get the parts, orders still seem good, especially on industrial and medical. Should we be thinking that the average to half run rate, that almost $500 million could be more of a base case for the first part of next year?

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

A

We're not providing guidance at this point. But I just think if you look at the relative mix of our business with semi and WFE, our customers have said WPE down 20%. We should be down, as Steve articulated, less than that, but still it's still down. And in the general, I'll say, broader at macroeconomic environment.

I think that would probably be a little high for a base case. So, obviously, there's a lot of moving parts in the economy right now. I think, however, our markets perform and that's maybe the first thing for you to form a view on is we should do we should do better than that. We're entering this softer point from a supply constrained environment. And so, we'll have an opportunity to fill in some inventory. We have new products and other things that should help us to relatively outperform the markets.

But I think that's the tough thing right now is looking at how the markets will perform in 2022. And I think there's still a lot of moving pieces there, Steve.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

Q

Got it. I'll ask one more. I know that securing wins in industrial and medical has been a big focus. As you've increased your sales and marketing, are you getting more inbound inquiries from new customers or can you talk about the percentage of customers that are finding you through marketing programs versus your direct sales channel?

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

A

Yes, Steve, I can make some general comments. But, I mean, the first thing we did was we – but there are sales force in – roughly 40% of the people are sales force from now solely incentivized on industrial and medical design wins and revenue. So we didn't have that before and that was a key change.

The second thing we did as a company was transfer a number of development engineers from our high volume programs, which were focused primarily on hyperscalers and networking customers, and we put them into the industrial and medical group. And so that's really opened up the pipe for engineering bandwidth and we've been applying that horsepower to new opportunities across the world, really. And so I think the company kind of refocused starting about 12 months ago on these applications. And we're able to engage with the customer with a pretty broad portfolio today, and basically customize the products to their needs. And so, it's a powerful playbook. It's going to play out the coming years, but it's a great business because most of these design wins last a very long time and the customers keep buying the product for as long as we make it.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

Q

Understood. Thanks.

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

A

Thank you, Steve.

Operator: 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

Let me add my congratulations on your record results. I just had a question about your large backlog. How would you look at the margin profile that backlog in terms of your recent margins? Would it be higher or the same?

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

A

Yeah. If you look at the backlog being 80% industrial and medical and semi, it's a generally margin up the company from our current run rate. I think the wildcard in that is how quickly do the premiums for – that we're paying to get for parts abate. But generally, it ought to be the same or better in the backlog.

Mark Miller
Analyst, The Benchmark Co. LLC

Q

You indicated the SL Power, the sales were slightly less than $100 million. What was the profit from SL Power contribution?

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

A

I think we said – I think we said SL Power was $17 million in the quarter of revenue. And we haven't talked about the specific performance of SL Power. But it's a business that operates in the mid- to high-teens of EBITDA and it continues to operate in that or a little better.

Mark Miller
Analyst, The Benchmark Co. LLC

Q

Thank you.

Operator: And we have reached the end of our question-and-answer session. And also, this concludes today's conference, and you may disconnect your phone line at this time. Thank you for your participation.