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PRESENTATION

Operator

Greetings. Welcome to the Advanced Energy Fourth Quarter 2021 Earnings Call. (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.

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

Thank you, operator. Good afternoon, everyone. Welcome to Advanced Energy's Fourth Quarter 2021 Earnings Conference Call. With me today are Steve Kelley, our President and CEO; and Paul Oldham, our Executive Vice President and CFO. If you have not seen our earnings press release, you can find it on our website at ir.advancedenergy.com. There, you'll also find the Q4 earnings presentation.

Before I begin, I'd like to mention that we will be participating at several investor conferences in the coming months. Now let me remind you that today's call contains forward-looking statements. They 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, February 9, 2022, and the company assumes no obligation to update them. Medium and long-term targets presented today should not be interpreted as guidance.

On today's call, our financial results will be presented on a non-GAAP financial basis unless otherwise specified. Excluded from our non-GAAP results are stock compensation, amortization, acquisition-related costs, restructuring expenses 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. Steve?

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

Thank you, Edwin. Good afternoon, everyone, and thanks for joining the call. We finished the year strong with revenue of nearly $400 million in the fourth quarter, a new record for Advanced Energy. For the full year, we achieved revenue of $1.46 billion, also a record performance. Demand for our products is very strong, and we carried a more than $900 million backlog into 2022. We are also pleased with customer acceptance of our new products and technologies across a wide variety of applications.

During 2021, we fine-tuned our growth strategy, clarified our product road maps, added senior management talent and increased the operating tempo of the company. We successfully integrated 2 acquisitions, Versatile Power and TEGAM, which brought valuable medical, sensing and calibration expertise to Advanced Energy.

Our short-term financial performance remains constrained by IC shortages. However, it's important to note that our engineering and marketing teams remain squarely focused on developing market-leading technologies and products, which will drive the long-term profitable growth of Advanced Energy. And our sales teams are focused on taking those new technologies and products to customers throughout the world. At our core, we are all about precision power technology leadership and delivering that technology in a way which adds value for our customers.

Now I'll provide more color on our fourth quarter and full year performance. Fourth quarter revenue and earnings per share surpassed the high end of our guidance. We secured additional critical ICs, which enabled us to ship more product than originally anticipated. This ability to quickly turn incremental parts into product revenue stems from a decision we made last year to keep our factories fully staffed, even though component shortages were constraining output. This full staffing approach gives us the surge capacity we need to take advantage of unexpected or lumpy delivery of critical ICs. And it paid off for us in the fourth quarter.

Moving to the supply chain challenges. The semiconductor supply chain remains dynamic. Most of the ICs we buy are built on mature process nodes, and that is where most of the industry-wide capacity constraints are. Many of our suppliers are working diligently to expand capacity. And most of that incremental capacity is scheduled to come online later this year or in early 2023. In addition, we are working closely with our customers to qualify alternative ICs with better availability.

In summary, we expect that IC shortages will continue to be an issue for much of this year, although we do expect improvement in the second half as new capacity comes online and our qualification and redesign efforts bear fruit. We continue to pay abnormally high prices to secure critical ICs in short supply. We also continue to experience unexpected supply decommits from certain IC suppliers. Given these factors, we are taking a prudent approach to our near-term outlook.

Now I'd like to provide color on each of our target markets. Our fourth quarter shipments into the semiconductor market grew sequentially and year-over-year. For the full year, we achieved record revenue despite persistent supply issues. And over the past 2 years, our semiconductor revenue grew by 76%. In the first quarter of 2022, we expect to grow semiconductor revenue sequentially and year-over-year.

At the SEMICON West trade show in December, we launched 3 new products for the etch and deposition markets, which featured advanced control capabilities. Also in the fourth quarter, -- we won multiple new designs with our high voltage, critical sensing and embedded power products.

In the industrial medical market, our fourth quarter revenue was up sequentially and year-over-year on improved component availability. In fact, fourth quarter as well as full year revenue in this market hit an all-time high. We expect robust demand in the industrial medical market in 2022 and carry the substantial backlog into the first quarter. During the fourth quarter, we launched 3 new industrial and medical products. In addition, we secured design wins in medical, test and measurement, horticulture and solar cell manufacturing applications.

In the data center computing, telecom and networking markets, fourth quarter revenues were well ahead of expectations due to improved component availability. During the quarter, we launched our next-generation 48-volt power shelf, which features 97% efficiency and industry-leading power density. Our telecom revenue grew in the fourth quarter largely due to increased demand for 5G infrastructure equipment.

Now I'd like to touch on our strategy and some of the changes we've made in the past year to accelerate our growth initiatives. Our overall strategy is to drive profitable revenue growth by delivering best-in-class precision power solutions to customers in our target markets. Our customers rely on Advanced Energy's innovation and technical talent to solve their most challenging power delivery issues. The solutions we develop are typically proprietary and are the foundation of our long-term growth strategy.

During 2021, we reorganized our product development and marketing teams to improve the speed and efficiency of our new technology and product development processes. We put a new leadership team in place, funding long-time Advanced Energy leaders with new leaders from outside the company. The team works well together and our shared priorities are clear.

In addition, we have allocated more engineering resources to the semiconductor, industrial and medical markets. We expect to increase our new product output and win more designs in these markets.

Finally, we have taken major steps to strengthen our operations and supply chain organization. We believe that we are well prepared to quickly turn, improve component availability into product revenue.

In closing, demand for our industry-leading precision power solutions remains extremely strong. We expect that a gradually improving supply chain environment, coupled with our shortage mitigation actions will drive revenue growth in the second half of the year. As a company, we remain focused on accelerating the execution of our long-term strategy to bring best-in-class precision power solutions to customers in our target markets.

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

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

Thank you, Steve, and good afternoon, everyone. In the fourth quarter, we delivered revenue and earnings per share above the high end of our guidance ranges. Good execution by our team allowed us to secure additional parts, increase factory output and begin to recover material cost premiums we've incurred. Demand also increased with our backlog growing another 20% to $928 million.

Our strong Q4 performance demonstrates that as we receive parts, we are able to quickly convert that supply to revenue. Looking forward, however, industry-wide supply constraints persist and the environment is very dynamic. As a result, we continue to plan prudently in the near term that see significant pent-up earnings potential as the supply environment improves.

Now let me go over our financial results. Fourth quarter revenue was a record $397 million, up 15% sequentially and 7% year-over-year. Sales into Semiconductor were $179 million, growing 3.4% sequentially and 8% from last year. Demand remains strong, driven by robust fab investments, and we expect Semiconductor revenue to grow sequentially again in the first quarter. Revenue from our Industrial and Medical markets grew 22% sequentially and 5% from a year ago to a record $99 million. We secured more parts than anticipated, allowing us to achieve the strong performance. Customer demand was broad-based, and our backlog in this market increased again this quarter.

Data Center Computing revenue rebounded to $80 million, up 29% sequentially and 23% year-over-year. Telecom and Networking revenue was $39 million, up 31% sequentially, driven by strong telecom shipments to 5G infrastructure, but down 16% year-over-year as a result of our portfolio optimization actions.

Non-GAAP gross margin for the quarter declined slightly to 35.5%, mostly related to increased material costs and unfavorable mix. In addition, during the quarter, we recovered from our customers a portion of the premiums we have incurred for purchasing high-cost materials. These premium recoveries benefited revenue but negatively impacted gross margin percentage by approximately 150 basis points. We expect increased material costs and premium recoveries to continue to impact our gross margin percentage in the near term but to improve later in the year.

Non-GAAP operating expenses were $86.1 million, up $2.5 million from last quarter. The sequential increase was due to investments in critical programs and higher SG&A expense. Operating margin for the quarter was 13.8%. Other expense was $2.5 million including $1.2 million of interest expense and $700,000 of foreign exchange losses. We expect other expense to be in the $2 million range going forward.

Our non-GAAP tax expense was approximately $850,000. The lower-than-expected tax cost was largely due to a year-end discrete benefit. Excluding this item, the adjusted tax rate would have been approximately 12.5% on a favorable mix of foreign earnings and increased R&D tax credits. Looking forward, we continue to expect our GAAP and non-GAAP tax rate to be in the 15% range. Earnings for the quarter were $1.36 per share compared to $0.89 last quarter. Excluding the discrete tax benefit, earnings would have been $1.21 per share.

Turning now to our full year 2021 financial results. We achieved record revenue of $1.46 billion, up 3% from 2020 despite the COVID-related impact on our operations and the industry-wide supply constraints. Semi revenue grew 16%, and Industrial and Medical revenue grew 9%, both to record levels. Sales into the Data Center Computing and Telecom Networking markets declined due to supply constraints of critical ICs and our portfolio optimization actions. Increased material costs related to supply constraints was the primary factor impacting our gross and operating margins. As a result, 2021 non-GAAP earnings declined year-over-year to $4.78 per share.

Turning now to the balance sheet. We ended the fourth quarter with total cash of $547 million and net cash of $154 million. Cash flow from continuing operations for the quarter was approximately $35 million and CapEx was $9.2 million. We made debt principal payments of $5 million and paid $3.8 million in dividends. In addition, we repurchased $21.5 million of common stock at $85.12 per share as part of our opportunistic share repurchase program.

Days of net working capital in Q4 decreased to 118 days on higher revenues. Inventory decreased slightly on a dollar basis and turns improved to 3.1x. We expect to see some upward pressure on inventory in the near term based on demand, but believe this investment allows us to respond quickly to customer demand as critical part shortages abate, and represents upside to operating cash flow over time.

Days payable fell to 68 days and DSO decreased to 54 days. For the full year of 2021, we generated $141 million of cash flow from continuing operations despite our investment in raw materials inventory while we await critical parts. In addition, we used $78.1 million to repurchase over 900,000 shares of our common stock during the year.

Now let me turn to guidance. We expect the supply environment to remain dynamic, with continued risk on timing of critical component deliveries. While our order book increased even after the strong Q4, we expect revenue will continue to be paced by supply. As a result, our Q1 outlook remains largely unchanged from the view we provided last quarter. We expect Q1 revenue to be approximately $360 million, plus or minus $20 million.

Our Q1 guidance assumes Semi revenue will grow sequentially, while revenues in the other markets will decline limited by availability of parts. We expect Q1 gross margin to improve slightly on lower volume. Overall material costs remain elevated, but we expect more favorable product mix and relatively lower material premiums and related recoveries. We expect operating expenses to be up slightly. As a result, we expect Q1 non-GAAP earnings per share to be $0.94, plus or minus $0.25 based on a share count of approximately 37.7 million shares.

Before I open it up for questions, let me make some comments beyond the current quarter. We entered 2022 with strong demand and record backlog with greater than 70% mix of proprietary products that can largely be shipped as soon as we can secure parts. Based on this, last quarter, we provided an outlook that called for revenue of over $400 million per quarter as supply improves towards the end of 2022. While we do not expect meaningful improvement in the first half, we remain confident in our ability to achieve these revenue levels or higher on a sustained basis as parts become available.

In addition, as premium costs normalize, we believe we can deliver greater than $6 per share of annualized earnings exiting this year with additional pent-up earnings potential in 2023.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Quinn Bolton with Needham & Company.

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

Nice execution in the fourth quarter. I guess looking at the strengths and the components you were able to secure in Q4, I have to assume your guidance implies that you think your components received in the March quarter are probably down about 10% or sort of in line with the revenue guide. Is that the way you're looking at component availability in the first quarter?

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

Yes, Quinn, let me make a comment. This is Steve Kelley. So in Q1, we're looking at our current line of sight for parts. So what we can see in front of us over the next 7 or 8 weeks until the end of the quarter. The second thing we're trying to do with our guidance in Q1 is to make sure we've got a relatively high degree of confidence in our midpoint guide. I think there's always a chance, we'll do better. But it's very hard to forecast these critical IC deliveries. Last quarter, we were surprised on the upside with an unexpected lumpy delivery of ICs. And we hope that happens again, but we can't forecast it.

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

So it sounds like that lumpiness that allows you to beat the fourth quarter is truly lumpy, and you haven't seen that activity continuing in the month of January and February to date at the same level you saw in Q4?

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

It's hard to characterize. I think we have received what we expected to receive so far this quarter. Typically, most of the action takes place in the second half of the quarter as our suppliers reallocate their product. That's a pretty dynamic process. So it's hard to forecast.

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

Understood. And then for Paul, so I was hoping you could give us a little bit more color on the premium recovery that you talked about. Premium recovery to me sounds like you're able to pass along some higher input costs or you're able to charge a higher price for your products, but I think you said that, that premium recovery actually was a drag on gross margins, but I think you said 150 basis points. Maybe I misheard, but can you just spend a minute and explain what's going on there with the premium recovery?

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

That's right. It's a good question, Quinn. So as we've noted, we're paying, in some cases, significant premiums to get parts sometimes just on the open market. Our customers support us getting those parts because it's sometimes the only path to getting product to them. And so we've been able to increasingly pass along that cost to them. However, when we pass that cost along to them, essentially, we're receiving revenue that covers the cost of those parts. So it's essentially revenue at 100% cost.

And so it's helped our revenue in the quarter, but it increased our cost sort of at an equivalent level. Now the good news is we recovered that cost. Otherwise, we would have just had the cost. But that's why you see a negative impact to the gross margin percent because you have more revenue going through not at our traditional margins but more at a cost recovery level.

Operator

And our next question comes from the line of Steve Barger with KeyBanc Capital Markets.

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Robert Stephen Barger - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

How much of the backlog is currently work in progress? And just waiting on ICs, I'm just trying to get a sense for how that will affect the working cap and cash flow as the year progresses?

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

Yes. I think the way to think about it, Steve, is when we look at what we would consider delinquent backlog, the product the customer was already wanting and that they want in the coming quarter, we would characterize more than 50%, maybe 60% or more is sort of shippable in the next quarter just awaiting those critical parts. Now we're not going to be able to ship all that because there's no way we'll get those parts in time, but it tells you that it's a very current backlog.

Now we've seen increases in the backlog that go out 1 or 2 or 3 quarters as well, but the vast majority is shippable as soon as we can build it. I think that's the way to think about it. And what that really means is that as we're able to get the critical parts and then increase our output, then we should be able to recover it pretty quickly. That's why we've kept the capacity in the factory. That's why we've kept everything on the ready. That's one reason why our other inventories are up higher than they've been because we have most of the full kits from any of these products and backlog, we just don't have some of the critical parts.

I think Q4 is an example of where we were able to get some parts, and we were able to turn around this very quickly, and you saw a little burst in revenues as a result of that. So it all comes down to how quickly and when we receive these critical parts. But certainly, as we look across the year and supply environment improves, it's what gives us confidence that we could operate at a much higher level in revenue and a much higher level of earnings as parts become available.

Robert Stephen Barger - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Yes. I guess to that point, I know you started requalifying new suppliers last year. And you mentioned that those efforts are underway, but can you be a little more specific about potential timing of that process? And realistically, when you could see some benefit that could help you start to draw down that backlog?

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

Yes. I think the team has done a good job working with our customers to quickly qualify alternate parts and also, in some cases, do redesigns of existing boards to accommodate new parts. So I think that, that has progressed very well. We expect the major impact to occur in the second half of this year. So we're seeing some positive effect in the first half, but most of it will take place in the second half of 2022.

Operator

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

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

I had a couple of them, too. First one, Steve, when I look at your Semi revenues last year, you said you grew 16%, and I understand supply constraints kind of really limited that growth. But if you look at your U.S. peer who has also experienced similar constraints. any business could almost twice your growth rate? So I'm kind of curious what's going on with your Semi revenue? Then I have a follow-up.

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

Yes. Let me answer your question in 2 parts, Krish. I guess the first is the strategic share, right? And that's really determined by wins or losses in our core market, which is conductor etch. And what we're seeing so far is that we're winning all the major opportunities there in conductor etch. So I think we're doing a pretty good job defending our strongest products.

In addition, we have some new technologies that will allow us to grow share in the coming years in some new areas like RPS and dielectric. Because I think when you're looking strategically at market share, you need to take a look at your design ends and then the time lag between design ends and production. But I feel pretty good about where we're at.

Your question is more on a tactical market share. And I guess our starting point would be 2020. If you look at the 2-year period, we've grown our Semiconductor revenues by 76%, which is ahead of WFE. We grew -- we outgrew in 2020 because our customers ordered early for the burst in 2021. And we underperformed quite frankly, in 2021 because of the parts issues that we ran into.

So our objective is to get better in 2022 from a shipment standpoint in semiconductor. So we intend to keep up with demand and also start rebuilding the hub inventories because last year, our customers cope with our shipping problems by eating into their hub inventory. And now we have to help them rebuild that inventory.

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

Got it. Got it. And then a follow-up for Paul. And I'm just trying to look at the linearity of the numbers in income statement. It looks like as the year progresses, your revenue should improve, and if and when supply constraints ease, you can hit like a $400 million run rate in quarterly revenues and the same in the second half gross margin should be better, a, is that right? And then how to think about OpEx? I try to do the math, it seems like your OpEx is going to outgrow revenue growth this year 2022, am I right?

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

Yes. So a couple of things, Krish. The first is that you're right. We would expect results to improve over the course of the year. But it's important to think about the seasonality of that. We do think that the parts environment that we're in continues to be challenging, and we expect that to continue not only to Q1 but into Q2 as well. And many of the actions that we have taken internally around part redesigns. And even when we look at when more parts are going to becoming available, we believe that's more in the second half. So we would expect to see Q2 very similar to Q1 when we look at our outlook just based on parts availability.

Now as those parts become available, as I mentioned earlier, I think we have upside to our revenue levels, which is why we've said that we expect to be able to exit the year at this $400 million rate or better.

And the second thing is, as this supply chain situation normalizes, and we don't have these, I'll say, premium costs where we're paying for higher-priced parts on the open market, that's going to also have a significant improvement in gross margin, which allows us, we think, to get to an exit rate of $6 a share and -- an annualized exit rate of $6 a share.

So we do think that the key to this is just parts availability and that there's a lot of pent-up earnings in the company. The question is timing and our best view of that timing is it second half. And exiting the year, we should be performing at a much higher financial level. Now you're right about operating expense, what we think operating expenses are going to be up about 6% year-on-year if you look at all the pieces. Most of that's inflationary, but you do have a little more cost from acquisitions we made during the year that have a full year next year. And because revenues are relatively flattish at the beginning of the year, if you just do the math, you'll see that the operating expense growth is probably a little bit higher than revenue.

Having said that, we believe that even with that growth, that exit rate of over $400 million in revenue and $6 per share annualized contemplates that operating expense growth. So we don't think it makes sense to cut costs in this environment. It's a supply-constrained environment. We've continued to invest in our critical programs in our people. We are seeing some inflationary pressures. We've taken some actions to combat that around efficiency and some reorganization that Steve's talked about. But fundamentally, we believe there's a lot of pent-up earnings in the model, and it makes sense to continue to invest through this soft spot that's created by the part shortages.

Operator

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

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

I joined the call late, so I apologize for repeating your question already being asked. Steve, I understand you may not want to comment on WFE. but some of your OEM customers have talked about $100 billion WFE this year, which is very substantial and hitting new highs. And I'm just wondering, when you talk about component availability in the second half of the year, should we assume that the way you're catching up with component and your shipment accelerate into the second half, would that be enough to support $100 billion WFE? And I have a follow-up.

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

Yes, Mehdi, that's a tough one. I think all indications from our customers are the 2022 and 2023 are going to be extremely strong. And if you take a look at the underlying fundamentals, they're very positive, right? So the trend towards 5G and artificial intelligence and Industry 4.0, et cetera, are driving some pretty strong secular growth. I think the other trend that's important is many of the customers for chips are moving to adjusting case inventory posture, which means not only just buying what they need but also putting some insurance in place from a parts standpoint.

And finally, you've got the number of regions in the world trying to become self-sufficient in chips, which is driving even more equipment. So I think WFE is likely to grow quite well in 2022. And probably, as an industry, we're going to be limited by parts, right? So it hits us, it hits the rest of the critical subsystem suppliers and it hits our customers. And so we all have to work together and make sure we get the parts we need to expand capacity in this very important ecosystem.

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

Sure. And just a follow-up to that. The same OEMs have a consistent message that this is secular and we are in a new paradigm shift, especially with localization and WFE will continue to grow probably through 2025. And given the premises what are the opportunities? Or what would it take for your OEM customer to become a partner with you and co-invest for supply chain, for hub inventory management so that once we come out of this later this year, both parties are able to help each other and benefit from these secular trends?

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

Yes. Mehdi, I think really it's not a question of money. We have the ability to expand our own capacity relatively quickly and at relatively low cost. The issue is getting the part. So it's really our suppliers expanding their capacity and their ability specifically to build more product at older nodes. So almost everything we buy is 28 nanometers to 180-nanometer type product. So it's mature. And it's been in contention this year as the automotive industry came back to life and basically economies boomed around the world. So we're all fighting for that limited capacity.

So what's happening today is we're seeing the [IDMs] make more investments in older nodes. And we're also seeing the same things happening at the foundries. So it takes some time to bring the capacity down, but it will come. And I think over the next 6 to 12 months, we're going to see things settle down.

Operator

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

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

Steve, just following up on Mehdi's question. So they think the OEMs will require you to hold a larger inventory going forward or maybe have a larger hub inventory going forward?

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

Well, yes, I think that 2 things will happen. One is our OEM customers will rebuild their safety stocks, and they may adjust those stocks a little bit depending on their risk tolerance. So that's probably going to be good news for us. The second is we're examining our own supply chain. And where we can, we're going to build inventory where we identify weak links. And we're also going to upgrade. So in many cases, we're buying parts that are built in factories that may not have a long-term expansion plans. And so at that point, it's up to our engineers to upgrade the technology so that we're using parts that will be available and plentiful for many years to come. So those 2 actions will be proceeding this year.

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

Okay. Great. And maybe just a little bit more color on the supply dynamics. When you get a slug of product like you did in the fourth quarter, is that driven by your core suppliers just giving you more allocation? Are they actually producing more? Are you finding new suppliers or possibly even buy markets?

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

Well, in this case, there was a couple of our core suppliers who allocated more to us. And there's a lot going on behind the curtain, quite frankly, that we don't see, but we're certainly happy to see the parts show up in our dock, and we put them into products and ship those products very quickly. And I think that's the power of our model, which is we've maintained full staffing and full capacity throughout the company despite the part shortage, so when we do get those upsides, we could turn them into revenue very quickly.

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

Okay. Great. And then, Paul, you talked a bit about the telecom business being down a bit on a year-over-year basis. How much of that was your portfolio optimization versus supply issues?

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

It's both. But I think if you -- I mean I'd have to think about it a little bit, but I'd say it'd probably be fair to say that it's half, 50-50 particularly in the fourth quarter a year ago, we had a very strong quarter in telecom and networking because we saw customers essentially buying ahead of products, ahead of price changes or phase-outs.

And then as you recall, in Q1, we moved to a lower number in the low 30s that we said was sort of a new baseline. Now we've had good demand off that new baseline this year that we've not been able to fill because of parts. And I think you saw a little bit of a glimpse of we got some parts in the fourth quarter, and we were able to bring that number up. So it's a combination of both things occurring.

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

Okay. And then last question here. When you look at the optimization, are you done with that process? Or is there still more to do?

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

I think in telecom and networking that's largely done, we tried to do this optimization effort, which is kind of an ongoing effort to kind of feather it in and blend it in, we don't want to put any of our customers in a difficult situation. We're trying to do this in a bit of an elegant way. I just think in that particular market, it ended up being more visible around that calendar year end. But we're constantly looking at how do we improve our portfolio, how do we raise prices in areas we have lower margins, how do we focus our engineering resources on areas that have more differentiation. So I'd say it's more of an ongoing process, but it shouldn't be as visible overall as what we saw in Telecom and Networking last year.

Operator

And our next question comes from the line of Pavel Molchanov with Raymond James.

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

Mine are actually not about the supply chain, believe it or not. In -- we're in the third year of COVID. And I wanted to ask what is the kind of near-term outlook for medical or the medical component of your Industrial & Medical segment. So are you seeing any deceleration in health care application demand as the pandemic kind of subsides, so to speak?

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

Yes. We're seeing indications of increased activity both on the revenue side as well as the design side. And so we're quite happy with the level of design wins that we're earning in that market. And also, we're seeing medical revenue pickup. So I think 2022 will be a good year for the for the medical market and a good year for us.

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

Okay. Interesting. That's a little counterintuitive. And then on the dividend. So I guess this quarter marks the 1-year mark of your institution of dividend, given that the yield on the stock, obviously, is pretty moderate, 50 basis points. Any perspective on moving to a progressive dividend policy or just -- any thoughts on that front?

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

Yes, it's a good question. Broadly speaking, when we put out our model, we said we sort of assign a portion of our cash flow to the dividend. Generally speaking, we said would review that periodically over time, which the Board does. At this point, we haven't made a decision to increase the dividend. Certainly, the company can perform at a higher level. We want to make sure we have cash in the right places, and we've not increased the dividend at this point. Certainly, that's something that we could continue to look at over time. But at this point, given the parts constraints, we've not increased the dividend.

Operator

(Operator Instructions) Our next question comes from the line of Paretosh Misra with Berenberg.

Paretosh Misra - *Joh. Berenberg, Gossler & Co. KG, Research Division - Analyst*

So besides some of the supply chain issues that are impacting your margins at the moment, are there actions that are under your control that can potentially help as well, for example, manufacturing footprint optimization and other cost-cut measures?

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

I'll make a comment and then turn it over to Paul. I think when you look at our costs, the great majority of the costs are in the bill of materials. And so there's not that much we could do trying to optimize manufacturing footprint that offsets the parts cost. In fact, we don't want to do that because we see a lot of opportunities to expand our manufacturing once the parts shortages are rectified. And so we're probably going the other way. We're probably going to build more capacity. It's relatively cheap. This is a fact we're building boxes and shipping those boxes after we test them. It's not a wafer fab, right? It's not a [clean room] It's relatively inexpensive capacity build.

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

Yes, I'll just add a couple of comments. Steve is exactly right. I would add, however, that this environment where you're struggling with full kits is quite disruptive, and it consumes a lot of time on the supply chain side, and it's quite disruptive in the factory. So we do believe that as the environment improves, there continue to be opportunities for us to also improve the efficiency of our operations. And that's something that we continue to focus on. We are carrying some additional cost from a factory that we are exiting in China so that we can have some of that capacity in place. It's not very efficient right now, but it does add ability for us to output more. So I think over time, there will certainly be opportunities for us to improve efficiency.

As it relates to cost, a lot of these increased costs right now, we think, are transitory. They're in the form of these material premiums that we're paying. Unfortunately, we're starting to be able to pass those on. It doesn't help gross margin percent. But over time, those will abate and that should improve our margins significantly. Now there's also some structural inflation in material cost, and we think, by and large, we'll be able to recover that largely through price increases over time. So we do think there's a clear path to get back to our model of gross margins of 40% or better. In fact, we believe we can be very close to that as an exit rate this year, assuming we see some of the abatement we've talked about in the in the supply environment.

Paretosh Misra - *Joh. Berenberg, Gossler & Co. KG, Research Division - Analyst*

Got it. And then this new next-generation 48-volt power shelf , how should we think about the potential for that product? How many other competitors can make a similar product?

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

I would say we were one of the first out there with a 48-volt power shelf for this level of efficiency and power density. So I think it more than meets the needs of the leading customers in the hyperscale market. So we think we're well positioned with this platform to move forward and to do further customization to meet our customers' needs.

Paretosh Misra - *Joh. Berenberg, Gossler & Co. KG, Research Division - Analyst*

Okay. And the last one for me. Just on the CapEx plans for this year, any large project we're flagging?

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

We always have a variety of things. Steve talked about some facility improvement, potentially some capacity increases around equipment. But look, our CapEx needs are pretty low, and I expect we'll stay within our model of 2% to 3%. We don't see anything that would drive us significantly beyond that -- 2% to 3% of revenue.

Operator

And our next question comes from the line of Steve Barger with KeyBanc Capital Markets.

Robert Stephen Barger - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

I know Industrial & Medical has been a focus for share gains and growth. And as you've gone through this team reorganization, have you seen those order rates accelerate? Or can you talk about book-to-bill rates for I&M versus the other segments or versus prior year, however you want to frame it?

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

Yes. We're not ready to get into that level of detail yet, Steve. But what I can say is we have significantly increased the number of engineers designing products for the Industrial & Medical market. So we are seeing increased output already. That's going to continue to increase in the coming quarters. The second thing we've done is really refocus a significant part of our and FAE force on Industrial & Medical applications. And so the pipeline is getting bigger. And we're definitely encouraged because this is really right in our wheelhouse. These are long life cycle, typically sole-source type products, and that's what we're good at.

Robert Stephen Barger - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Yes. To the extent -- go ahead.

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

I was just going to say -- just commenting, Steve, just -- this was a record quarter for Industrial & Medical from revenue. Steve commented that on his prepared remarks. And we also noted that backlog increased again for these products. So clearly, there's a lot of demand. We're winning new positions. And as we get parts, there's a lot of room for revenue growth here.

Robert Stephen Barger - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Yes. That was my follow-up. For the Industrial side, are you targeting niche manufacturing of really specialty products? Or -- and on the Medical side, is it really medical device manufacturers? Or what's kind of the approach that you're taking?

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

Yes. Steve, I would say most of the opportunities here are going to be small and medium-sized opportunities. So we -- it's a lot of singles and doubles in the Industrial & Medical market, but the opportunities last for a long time. So we're able to build upon them at each of these customers. So that's really kind of business it is, and it tends to average up our corporate gross margin. So that's why we've put so much horsepower behind that effort.

Robert Stephen Barger - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Yes. So it mixes you up as that growth accelerates?

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

Yes.

Operator

And we have reached the end of our question-and-answer session. And therefore, I will now turn the call over to Steve Kelley for closing remarks.

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

Okay. Thank you. A few closing thoughts. First, demand for our products is very strong; second, as supply conditions improve, we expect to drive improved financial performance; and finally, we are focused on accelerating the execution of our strategy to bring best-in-class precision power solutions to customers in our target markets. And thanks for joining the call today.

Operator

This concludes today's conference, and you may disconnect your lines at this time. Thank you for your participation.