

Company Name: Advanced Energy Industries (AEIS)
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<<Analyst, Robert W. Baird & Co.>>

Hi, I'm Rob Mason, Senior Equity Research Analyst at Baird covering the Advanced Industrial Equipment Sector. Maybe for those less familiar Advanced Energy Industries is the high-end supplier of precision power, programmable power solutions across a range of industries, industrial and medical being a particular area that they're focused on for growth and it plays more strategic emphasis on. So, pleased to introduce from Advanced Energy Steve Kelley, the President and CEO; Paul Oldham, CFO; and also joining us, Edwin Mok, who oversees Strategic Marketing and Investor Relations. I think Paul is going to start off with a quick Reg FD disclosure and then Steve is going to make some comments as well.

<<Paul Oldham, Executive Vice President and Chief Financial Officer>>

Great, yes. Just a quick reminder that today's comments may include some forward-looking statements, which are subject to a number of risks and just encourage you to look at our SEC filings for further description of those risks. We did have our Q3 earnings release last week, so have a look at that for any guidance or other information. We won't be providing any updated guidance today.

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So maybe Steve, I'll hand it off to you if you want to make a few remarks just to kind of open us up. I was thinking maybe a little bit of historical context on the company, your semiconductor equipment origins, but also more importantly, maybe the journey to expand in some other markets.

<<Steve Kelley, President and Chief Executive Officer>>

Yes.

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I mentioned industrial medical being one, but I'll let you elaborate.

<<Steve Kelley, President and Chief Executive Officer>>

Thanks, Rob. Doing a sound check, we're okay? Okay. So Advanced Energy, we're located in Denver, where our headquarters is. We're about a 42-year-old company. Our roots are in plasma power. So we started the company based on our knowledge of how to deliver RF energy into a plasma chamber and keep the plasma lit. So our biggest customers are Applied Materials and Lam, and over the years, we've built a close relationship with both those companies, and we're

basically considered a supplier of critical subsystem equipment to the semi-industry. Over time, we've made many acquisitions and accumulated many products that fit into other spaces.

The most prominent space that we go after today is industrial medical, after semiconductor. We like industrial medical because it's primarily sole source, so it's very similar to semiconductor, and once we get the design win, there is a single source. It's us. And so roughly 70% of our revenue as a company comes from sole source products. Now, some of those products start off as standard products. They start off as an off-the-shelf item, but most of our customers don't want off-the-shelf. They want us to customize it to meet their particular needs, and that goes across semiconductor, industrial and medical.

We're a high-tech company. We have locations around the world. Our primary manufacturing facilities are in Malaysia. They're in the Philippines, in Mexico. We also have some presence in China. So last year, we did about \$1.85 billion in revenue. We generated a lot of cash flow. Last quarter, we generated \$73 million worth of cash. And so what we've done with the company over the past few years is to try to balance our exposure. So in the past, we were primarily a semiconductor company, and we kind of rode the wave up, rode it down. What we've done in the past year is show investors that we're more than just a semiconductor company. We're also a very strong industrial, medical, telecom, and data center. What that's done for us this year is offset somewhat the cycle. So yes, our sales are down this year, but not really as much as they would have been if we were solely dependent on semiconductor. So I think we're a safer bet for investors moving forward.

<<Analyst, Robert W. Baird & Co.>>

Very good. And maybe just to extend those comments, Steve, just exactly what are you seeing across your various end markets at this point?

<<Steve Kelley, President and Chief Executive Officer>>

Yes. So let's just march through the end markets. I think the semiconductor equipment market has been well chronicled. I think going into 2023, we knew the market would be down, and it has been down, but we were able to plan accordingly, and we offset some of the cyclicity through strength in areas like service and also our presence in high voltage, which has remained strong due to demand for silicon carbide and high-voltage transistors. So I think we've had a reasonably good year in the semiconductor, even though we're down roughly 20% in semi.

Moving forward, most of our customers in the semiconductor are saying that they expect 2024 to be flattish than 2023. We're starting to see some room for improvement, but I think most of our customers are staying conservative right now, but I think the bias is probably to slight up in 2024 for semiconductor. To move beyond semiconductor into industrial and medical, we've had a very strong year in 2023, and that strength continues into this quarter to Q4. But moving forward, I think it's less visible exactly what's going to happen in 2024. Lead times have come down significantly over the past six months, where it used to be 50 weeks for a product, now we're 15 weeks and going to 8 or 10 weeks.

And so when you compress lead times like that, customers don't feel a need to give much visibility beyond the current quarter, maybe into the next quarter. And so we're exercising our forecasting muscles as we move into 2024, and we'll see where it goes. I think in our other markets, data center and telecom, data center market has been sluggish for a while as the big data center players digest some inventory. So we expect that market to pick up again at some point next year. We can't predict exactly when, but this is a very cyclical market, and it tends to be herd-like when all of a sudden everyone wants product again, and so we're racing to catch up. And that's what we've seen time and time again with that market. And I think with telecom, I think we're expecting that to be relatively slow. I think Paul mentioned the \$30 million a quarter, very flattish next year. The catalyst in the past has been 5G and shipping some overdue backlog this year, but we don't seem to make catalysts for growth for telecom for next year.

<<Analyst, Robert W. Baird & Co.>>

Maybe we could just return back to the industrial and medical discussion there. Just give us a feel for the different applications within industrial and medical, where you participate. Again, maybe the stickiness and the duration of what some of those sole source opportunities look like for you.

<<Steve Kelley, President and Chief Executive Officer>>

Let's start with medical. Now it's roughly a quarter of the industrial, medical revenue, a wide variety of applications. Basically, in medical, the customer is looking for high reliability, durability, and in precision, because medical there is no room for error. Basically, they can't afford for the power supply to have a glitch or to stop working. And so what we offer customers is a broad portfolio, a lot of exposure to our engineers, and certified production lines. So we're certified to these various medical bodies. And we have not just Asian manufacturing for medical, but also Mexicali as an onshore manufacturer, which for many medical customers, there's a preference for an onshore manufacturing source.

Moving beyond medical, we do a lot of work in thin films, leveraging our expertise in plasma power. And beyond that, it's a wide variety of applications, everything from LED lighting to test and measurement and a thousand other applications in between.

And so for us, the rest of industrial is fertile ground, because until a couple years ago, we really didn't focus on industrial and medical. And so the business didn't grow as fast as it should have. For the last two years, we have been focusing on industrial and medical. We refocused half our sales force, we pay them only on industrial and medical revenue and design wins. And we're starting to see the fruits of that new focus. So for us, we expect to grow industrial and medical probably twice GDP moving forward. So the sales force helps, a lot more new products help. And then our new website helps as well. So we just launched a website in August, which is quite useful for people to find exactly what we make that fits their needs. We didn't have that before.

<<Analyst, Robert W. Baird & Co.>>

And to the extent that you have repositioned the sales force around that, incentivized around design wins, what's the – you're seeing early traction there. But what would be the normal expectation around how long it takes to seed and capture a design win from start to finish?

<<Steve Kelley, President and Chief Executive Officer>>

Yes, I think the longest design cycles are in semiconductor and medical. So medical would be the longest runway between the win and the actual volume. Industrial varies, it depends on the application, but also it depends on the region. So we see our success in Asia converts into revenue fairly quickly, where it may take longer in the U.S. and Europe. And I also think that the higher reliability required by the application, typically that translates into longer design cycles and so some of the less sensitive applications can ramp the volume pretty quickly.

<<Analyst, Robert W. Baird & Co.>>

One thing that we just happened to have noticed, maybe more acutely here in the third quarter, is for certain OEM suppliers, there has been some de-stocking and pulling inventory down at the OEM level. Is that a dynamic that's working through any parts of your business, either in the third quarter or that you expect to see in the fourth quarter?

<<Steve Kelley, President and Chief Executive Officer>>

It's hard to make a general statement because we have so many customers in industrial and medical. I think that's certainly the case for some customers. But what we see is in industrial and medical, we have so many different submarkets that we'll have some customers who are going through a de-stocking phase. We'll have others that are going into Hyperdrive. And so at the top level, things tend to cancel each other out for us, at least they have so far in 2023. So that's part of the beauty of the industrial and medical market, is you spread your risk across many different customers, regions, and applications.

<<Analyst, Robert W. Baird & Co.>>

Maybe I'll pause there. If anybody has any questions from the audience, we'll be able to – just raise your hand and we'll take those. We'll continue on.

Steve, I'm going to just –

Q&A

<Q>: May be just following on the gross margins going forward [indiscernible] (0:11:40)?

<A – Paul Oldham>: Yes, I can comment a little bit on that.

<A – Edwin Mok>: Can you repeat the question?

<A – Paul Oldham>: I am sorry. I'll repeat the question. The question was can we give a little color on gross margins going forward? We've been running about 36% gross margin, plus or minus the last few quarters on lower volume. And then last year, of course, to the question, we paid a lot of premiums during the supply chain shortages. We were paying really significant amounts to buy the parts in kind of a third-party market. Our goal is to get to 40% gross margin.

And when you look at the components to get to there from here, we still have about 100 base points of headwind related to those premiums. We expect those largely abate over the course of the next quarter or two, so that will help. We also have a lot of things we're doing to optimize our factory footprint. We're consolidating activity from numerous smaller boutique factories into our larger factories that Steve referred to earlier, and doing a lot of optimization around our supply chain and other areas. We think that will add about 100 to 150 basis points of gross margin. So, if you look into next year and you assume we're sort of flattish, we ought to see 150 or 250 basis improvements of gross margin. So on a flat year, we believe it will be up.

That doesn't get us to our goal of 40%. And to get there, we'll have to see volumes recover a bit. If we saw volumes back in the mid to high \$400 million range, that's going to add another 100 to 100 plus basis points of margin. So there is a pretty clear path to getting back close to 40% or better.

Our long-term goal is to be above 40% in good markets and bad. And what will help get us to that point is the continued work on our product portfolio, a lot of new products we're introducing in our higher margin areas like semiconductor and industrial and medical. We think that adds 100 basis points to 200 basis points overall. So if we look out past the next up cycle, maybe to the next down cycle, whenever that is two, three, four years from now, we would expect maybe our trough margins are closer to 40% instead of where we are today because of those factors all contributing.

That means there's still a lot of earnings potential in the company that we think we can accelerate earnings through the next up cycle. That's just saying that somewhat through the next down cycle versus where we are today.

<Q>: Maybe – I'm sorry, do we have any more questions? Continue on the industrial and medical real quickly, Steve, just, again, talking about some of these commercial changes and go-to-market shifts that you've had, how should we be thinking about the mix of business ultimately from direct versus distribution, I guess, versus e-commerce related you mentioned the website.

<A – Steve Kelley>: Yeah, yeah. So the industrial and medical business is the one business we have where we actually use distribution as a channel. Because in the semiconductor and data center, almost all the business is direct. So for us, distribution is a key part of our strategy for industrial and medical. Today, right around 45% of our business industrial and medical goes to distribution, and 55% is direct.

So looking forward, we're going to add e-commerce to our website in Q1. And our intent there is to make it easier for customers to get samples quickly to evaluate those samples quickly. But we don't plan to sell volume products through our website, right? So we're going to steer that

business to distributors, and we'll take some of it direct depending on the size of the customer and their strategic importance.

But today, we think the website together with the increased focus from our own sales force, as well as the distributor sales force, opens up a lot of opportunity. And the reason we say that is not just because of products, it's also because of our competition. In this market, this industrial and medical market is highly fragmented. Nobody has more than a single-digit market share, including us, and we're number one or number two here today.

So we think there's an opportunity to out resource our competition. We can bring more applications, people to bear, more salespeople. We have better factories. We have better quality standards. We can beat them across the Board if we focus on it. That's our strategy.

<Q>: Very good. Maybe touch on the semiconductor business real quick, and just shifting over there. Starting off, how are you seeing the impact on a go forward basis perhaps, within China to export controls on your business? What may be left to roll through there?

<A – Steve Kelley>: Yeah. That's a good question. So October of last year was when the more stringent export control regulations were promulgated. And at the time, we stopped shipping into China. We stopped shipping our power products into China. And over the course of five months, we developed a very rigorous, labor intensive protocol, so that we can ensure that when we started shipments again, that they ended up in the right fabs in China.

So we did restart shipments into China in the second quarter of this year. And we've continued to ship through Q3 into Q4. That said, our shipments are down, because obviously we're not shipping products into the prohibited fabs. So that had an impact on our overall revenue. But it's also important to put it in perspective.

Our shipments directly into China were low-single digit percentage of our overall revenue. So it's not a big hit. More importantly for us is the impact on our customers, on our direct customers, the applieds and lamps and other big OEMs. And they've had to deal with this, and they've navigated it.

Obviously, it's impacted their business a bit. But I think their regulations now are fairly clear. We know what to do. The latest update that came out a few weeks ago really didn't impact us incrementally.

<Q>: Okay.

<A – Steve Kelley>: Yeah.

<Q>: And then just from a regionalization dynamic that's going on in that industry, have you given any insight on the timelines there in terms of when that would start to have a material impact on Advanced Energy?

<A – Steve Kelley>: Yeah. I think you're basically talking about the subsidies offered by the U.S. government, Europeans, Japanese, et cetera. And I think it's good for our customers, obviously. I think there is very limited impact this year. I think we'll start to see some impact in our business next year, positive impact. And moving forward as these subsidies flow through, if it helps our customers, it helps us.

<Q>: Maybe zooming out a little bit on the semiconductor business, just to have a better understanding there, because you do have some very strong well-entrenched position of some key customers. What has been your competitive advantage in that space? And how did you end up in that position?

<A – Steve Kelley>: Yeah. The semi-equipment market is an interesting market. It's all about performance essentially. So when we're competing at the design-in stage, our customers are looking at two things primarily. One is throughput, the other is yield, right? And so if we come up with a technology that's clearly superior to our competition and at a reasonable cost, then we're going to win. And if we don't, then we're going to lose. It's pretty simple. So it's a really performance driven market.

How do you keep the business? Well, you become a reliable supplier. And so that goes to our manufacturing, it goes to our quality standards over time. And I think over 40 years, we've developed a good reputation for manufacturing excellence and quality focus. So those three things, performance, manufacturing excellence, quality, I think those are the three differentiators. And again, it's all driven by engineering excellence. And so we have a team that's been doing this for many, many years, and it's difficult to duplicate what our engineering team should do.

<Q>: Relatedly, I know, you've announced some new plasma platforms. How should we be thinking about the significance of those timeline to ramps or just how those would play into the outlook the next couple of years?

<A – Steve Kelley>: Yeah, we made a major announcement in July at SEMICON West in San Francisco. We announced two new platforms for semiconductor plasma systems. One's called eVerest, one is eVoS. And they're basically a clear step up from state of the art out there today. And the products have been extremely well received by our customers. And the reason is, our customers are trying to become more efficient, higher yields, better throughput at sub-2 nanometer geometries.

It's very, very difficult to etch and deposit at these very small geometries. And so the technology we're bringing to them, enables them to do that. And so the pull on these technologies has been tremendous and we're hustling basically to fill orders. So it's highly unusual. Typically, in this market, it takes two or three years for these things to be qualified and purchased. We're seeing this happen within six to twelve months. So just across the board, our entire customer base.

And so right now what our team is doing is we're working closely with our customers to take these platforms and then customize them, because every application is a little bit different. And so we basically work with our customer to tweak the performance of our systems, so that it meets

their needs. This is typically a six to 12-month process with each customer, so we're about halfway through it for many of our customers.

<Q>: So if we think about some ability to potentially outgrow the semi market next year, does that – those products play into the mix or are there other things that you decided...

<A – Steve Kelley>: I think the new products play some part, but it's really going to be an impact starting 2025, you have to look at when these 2-nanometer and less processes actually go to volume at TSMC and Samsung and other customers. I think 2025 is when that begins in earnest. But it keeps us – it gives us the ability to grow market share from 2025 into the 2030s, essentially. So we're very excited about that. And then we complement that technology with other technologies, we introduced some other solutions for remote plasma source applications, more high voltage products. And so I think the new product story at Advanced Energy is a very good one.

<Q>: Any other contributors, as you think about 2024 potentially, for outmarket growth?

<A – Steve Kelley>: Yeah. I think that it really depends on how fast these various markets pick up. So you need to think about the semi market in a segmented way, right. So there's memory. Within memory, there's NAND and there's also DRAM. So you have to figure, when are these markets going to recover? I'm not going to opine on that, because there's plenty of people smarter than I am to talk about when the memory market is going to recover, but it will recover. The second thing to think about is advanced logic. And again, this market is driven by cell phones, by smartphones. It's also driven by high performance computing. And so high performance computing continues to be a pretty hard market, driven by AI and other types of applications.

And we know the smartphone demand will come back stronger at some point as well. The last market is, what I call, the good enough market, right? It's everything else, and that's the biggest market. And so these are analog chips, they're microcontrollers, they're discretés, they're older technology logic, et cetera. And this market continues to steam along. We saw that in 2023, the expectations from our customers is that that market will continue to be healthy through 2024.

And so as you think about the semiconductor market, that's how you should think about it, in at least four segments, and they all have different cadences. But there's one constant we never can predict the upturn, right? It happens all of a sudden, and then we're off to the races again. So our position as a company is to be conservative financially, but operationally to be ready. So we know what happened in 2020 and 2021, because parts became a big issue. It constrained our output.

We don't want that to happen again. And so we know where the weak points are in our supply chain, and so we're putting place inventory so that these parts don't constrain us moving forward. In addition, we are basically probably keeping more staff than we need in our factories, which allows us to surge. So when the demand comes, we could act quickly and satisfy.

<Q>: You touched on the data center and telecom markets, or at least the near-term outlook there, perhaps being a little softer, how are you going to manage those business in the near term around that type of market?

<A – Paul Oldham>: Yeah. I think in those markets we have a little bit different strategy. We have a selective strategy to focus on areas where we bring a clear value to customers and therefore can secure a sole-source or maybe the pole position and dual source position, rather than going after higher volume commodity like applications. We've been quite successful at that. In the hyperscale and data center markets, we've added several hyperscale customers. Even this last quarter we were able to ramp an application with the sole-sourced design based on advanced computing as Steve mentioned earlier.

And so our goal there is to increase the profit, maybe not grow the revenues as fast, but increase our profit levels and focus on areas where we have opportunities to win. As Steve said earlier, I think if you look at those markets, particularly data center market next year, I think that, well, depending on timing of customer orders. And we ought to see some recovery in that market. And then in the telecom market, we do expect that to settle back down to a more normalized level, particularly given the weakness in telecom equipment.

<Q>: That level being about 30 million...

<A – Paul Oldham>: About 30 million.

<Q>: ...a quarter, and the volatility around that, do you think that pretty stable...

<A – Paul Oldham>: Volatility around that should be relatively stable, but again, sometimes with these equipment companies, you can see a little pops and orders depending on what's happening with the customer. But we expect that market to be pretty steady next year but at a lower level. Look, we benefited a lot this year because I think there was 5G was a driver. But also if you look back at the last two years, we were quite part constrained. And so we were able to fill a lot of that demand in the last year as we were able to get parts in that market.

<Q>: And Steve, you touched just a little bit on just maybe the manufacturing strategy, at least here in the near term around capacity. You're also moving repositioning some of your capacity as well. Can you just give us an update on the timeline there and what the expected benefits?

<A – Steve Kelley>: I'll talk about the timeline. I'll give the benefits over to Paul. But what we're doing in manufacturing is we're consolidating a number of small factories into our big factories. The best way to think about it. So I talked earlier about many acquisitions we've made over the years. We typically inherited a small factory with the acquisition and never really integrated that into our manufacturing network. So we've got a full court press on now to integrate these factories into our big factories. It's going to lower our cost base, it's going to improve our quality, and it's going to reduce our inventory essentially. So this is being led by our Chief Operating Officer who joined the company a couple years ago.

At the same time, we're planning for the future. So we announced recently that we're building a new factory in Thailand, and that'll be ramping in 2025. So we think it'll be ramping just at the time that we need it. So initially we're going to put in that factory, the semiconductor plasma products. But over time we'll be making all of our products in that factory. So at the end of the day, we're going to have four major sites for manufacturing, Thailand, Malaysia, the Philippines, and Mexicali, Mexico.

<A – Paul Oldham>: And just commenting on that financially, that's embedded within our discussion about optimizing our factory footprint. So although we're making some investments in Thailand, we're ramping in Mexico. Net-net, this will be a costly reduction for us because we'll be able to take advantage of lower cost regions, higher efficiency in these larger factories. And even our CapEx target of 3% to 4% contemplates the investments that would make in Thailand into other areas. So net-net will have a more consolidated, more efficient manufacturing footprint that ought to service well for many years to come.

<Q>: Very good. And maybe in the time we have less, I want to touch on just the capital allocation strategy. Clearly, you have an interest in inorganic growth representative, but some of the actions you took earlier this year, just maybe some of the criteria that you're looking at and just maybe your overall approach on M&A?

<A – Paul Oldham>: Yeah. So look, we participate in large fragmented markets that are largely sole-sourced. And so the opportunity for us to sort of expand our product portfolio, expand our scale through acquisitions, a meaningful one, and we've done a lot of acquisitions over time. Basically, we're looking things – for things that align with our strategy that aligned with our being a leader in electric power conversion. When we focus on that, we're able to sort of expand and then get a lot of scale from the acquisitions that we've done. So we've allocated the majority of our funds, if you will, to growing the company through smart M&A. We have a good track record of doing that. We recently raised some money through a convertible offering, which gives us a very strong balance sheet and flexibility to pursue larger M&A. But we have flexibility with that. I think we're pretty disciplined in that process. And if we're not able to find something that fits our criteria, we have the ability to arbitrage of our existing debt over time from that equity raise as well.

<Q>: And upper limits on kind of leverage that you are comfort?

<A – Paul Oldham>: Yeah, we've targeted 3x net debt is kind of the upper limit. If we saw a large transaction that made a lot of strategic sense, we could go a little higher that with the intent to deliver. We're nowhere near that today. We actually have net cash today. So we have quite a lot of firepower on the balance sheet to put to work if we find the right opportunities.

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Very good. Very good. We're at time. We'll break there. But I want to thank Steve, Paul...

<<Steve Kelley, President and Chief Executive Officer>>

Thanks, Rob.

<<Analyst, Robert W. Baird & Co.>>

Appreciate it.

<<Steve Kelley, President and Chief Executive Officer>>

Yeah.

<<Paul Oldham, Executive Vice President and Chief Financial Officer>>

Thank you, Rob. Thanks, everyone.