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Advanced Energy Industries, Inc. (AEIS)

Q4 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings, and welcome to the Advanced Energy Fourth Quarter 2022 Earnings Call.

At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Edwin Mok, Vice President of Strategic Marketing and Investor Relations. Thank you, Edwin. 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 fourth 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 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 8, 2023, 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. Excluded from our non-GAAP results are stock compensation, amortization, acquisition-related costs, facility expansion and related costs, restructuring charges and unrealized foreign exchange gain or loss. A detailed reconciliation between GAAP and non-GAAP measures can be found in today's press release.

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

Stephen Douglas Kelley

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

Thanks, Edwin. Good afternoon, everyone, and thanks for joining the call.

We delivered strong results in the fourth quarter, taking advantage of healthy demand, improved component availability and solid manufacturing execution. For the full year, we achieved record revenue of $1.85 billion and record earnings per share of $6.49, thanks to robust demand across all of our markets and improved execution across the company. Sales into each of our markets grew 20% or more in 2022. Overall, our operational performance improved throughout the year due to better component availability, successful qualifications of alternative parts and redesigns, and good manufacturing execution.

We doubled the number of new product launches in 2022. By and large, these new products employ leading-edge technology and are proprietary in nature. These products led to additional design wins in 2022, particularly in the industrial, medical and semiconductor markets. Moving forward, we expect design win activity to accelerate in 2023, as customers shift their focus from supply chain issues to product differentiation. We believe our leading-edge power delivery solutions enable our customers' new products and will fuel our profitable growth for years to come.

In 2022, we successfully integrated SL Power into Advanced Energy. SL expanded our position in the medical power market, where we are now one of the top players. In addition, we are adding capacity and capability at the former SL Power factory in Mexico to accommodate customers who prefer a North American manufacturing site.

Now, I'd like to provide some color on the current supply chain environment. Scarce components are still gating revenue in the industrial, computing, telecom and networking markets. Power ICs and FETs are the two most significant constraints. These trailing-edge products are widely used across the electronics industry, particularly in automotive and industrial applications. In semiconductor equipment, we are seeing fewer parts shortages. This has allowed us to reduce lead times for some of our products, which in turn has enabled our customers to normalize their order backlog.

Now, I will provide more color for each of our end markets. In semiconductor, fourth quarter revenue increased 30% year-on-year to $232 million, in line with our expectations. For the full year, Advanced Energy revenue in this market grew over 31%, much faster than overall WFE. In the fourth quarter, we secured new design wins in wafer inspection and remote plasma source applications. We also introduced new technology platforms for advanced etch.

In the industrial and medical markets, fourth quarter revenue grew more than 20% year-on-year to $119 million. Despite those record shipments, our industrial and medical order book still increased in Q4. In the medical market, we secured several new wins in surgical, medical laser, diagnostic and life science equipment. In the fourth quarter, we launched FlexiCharge, the industry's first high-voltage capacitor charger and low-voltage power supply in a single integrated product. We designed this product to meet the power needs of medical laser applications by combining our industry-leading high-voltage and configurable power supply technologies. Initial customer feedback has been enthusiastic. In the industrial space, we secured design wins in 3D printing, industrial laser and test and measurement applications.

Now, moving to our computing, networking and telecom markets. Fourth quarter revenue from data center computing customers totaled $95 million, a new record for the company. Telecom and networking revenue grew 15% year-on-year to $44 million. Our upside in both markets was driven by improved component deliveries late in the quarter, coupled with our ability to quickly turn those scarce parts into revenue.

Now, move to the 2023 demand picture, as well as our priorities for the New Year. We expect that 2023 will be a down-year in the semiconductor market and are taking actions to lower our cost structure to adapt to this new demand environment. Even though overall semiconductor revenue will be down year-on-year, there are pockets of strength, including our service business, our high-voltage ion implant products and recent design wins which are still ramping to volume. Because of these pockets of strength, we believe that we will perform better than the market in 2023.

Outside of semiconductor, we believe that 2023 revenue should be relatively stable year on year. We carried a large order book into the first quarter due to a combination of healthy overall demand and lingering parts shortages. Also, we believe the variety of markets we sell into will have a smoothing effect on the aggregate revenue in our non-semiconductor markets.

Now, moving to the priorities for 2023. Our first priority is to maintain our new product and design win momentum. We want to be the technology leader in every market we serve. To do that, we intend to maintain our investments in R&D and push our development teams to move even faster. The second priority is to improve the efficiency of our manufacturing and supply chain operations. We made a lot of progress in 2022 and can make even more in 2023. We will optimize our factory footprint and streamline our network of subcontractors and component suppliers. We learned a lot about the strengths and weaknesses of our supply base over the last two years and intend to concentrate our business with the best performing suppliers.

The third priority is to increase our engagement with customers across our markets. We have a large, talented sales and applications team and a strong network of distributors and value-added resellers. We intend to use this worldwide team to focus on the needs of fast-growing small and medium-sized customers, while maintaining high service levels at our larger customers. Finally, we will take special care to control discretionary expenses in 2023.

I would like to close with a few parting thoughts. First, we just wrapped up one of the best years in Advanced Energy's history, delivering record financial performance and a record number of new products. Second, we are carrying that momentum into 2023. We will go full speed ahead with our R&D efforts and improve our efficiency across the company. Finally, we believe that our increased participation in a variety of high-value markets coupled with our pockets of strength within the semiconductor market will allow Advanced Energy to perform substantially better than in past semiconductor market slowdowns.

Paul will now provide a more detailed financial information.

Paul R. Oldham

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

Thank you, Steve, and good afternoon, everyone.

We delivered strong financial results in the fourth quarter and a record 2022, as we secured additional supply of scarce components and began to leverage our backlog and low channel inventory to perform better than the market. Fourth quarter revenue of $491 million and EPS of $1.70, both reached the second highest levels ever for the company. Overall, revenue grew 24% year-over-year and 18% organically. In the fourth quarter, backlog declined to $875 million, down from $1.1 billion at the end of the third quarter. Approximately 40% of the sequential decline came from the China-based semiconductor customer orders, which we moved out of our reported backlog, but were not canceled.

The rest of the reduction in backlog reflected lower demand and changes in ordering patterns from our semiconductor customers as we improved our lead times. Backlog for non-semi markets remain unchanged quarter-on-quarter despite robust shipments. As we further resolve critical part issues, we expect to work down our total backlog over the next several quarters to a more normalized level of $400 million to $500 million.

Now, let me go over our financial results in more detail. Revenue in the semiconductor market was $232 million, up 30% year-over-year, but down 13% from a record Q3. Roughly half of the decline was a direct result of the China-based export control regulations announced in the quarter. In addition, our customers lowered their build plans in response to the current environment, which was partially offset by our ability to largely restart customer inventories back towards normalized levels.

Revenue in the industrial and medical market was $119 million, up 21% year-over-year and flat with last quarter's record level. We continue to be parts constrained in this market and believe we have upside as component availability improves. Data center computing revenue was up 18% year-over-year and 8% sequentially to $95 million, a new quarterly record. Telecom and networking revenue was $44 million, up 15% year-over-year and 4% sequentially.

Fourth quarter gross margin was 36.6%, down 90 basis points from last quarter due primarily to less favorable revenue mix, lower volume, and continued higher material costs. Although we began to see some moderation in premiums and recoveries toward the end of the quarter, we expect higher material cost to continue to impact our gross margin through the first half of 2023, with gross margins gradually improving in the second half of the year as premiums abate and historical costs flow through our inventory.

Operating expenses were $101 million, up slightly from last quarter mainly due to timing of programs and infrastructure investments. Operating margin for the quarter was 16%. Depreciation for the quarter was $9 million and our adjusted EBITDA was $87 million. Non-GAAP other expense was $1.1 million on better interest earnings, partially offset by foreign exchange losses. Given higher interest earnings on our cash and the benefits to interest expense on our swap, we expect our non-GAAP other expense to be in the $1 million range, plus or minus going forward.

During the quarter, we initiated a restructuring plan and recognized $5.6 million in restructuring costs, primarily associated with the integration of SL, consolidation of certain production into our higher-volume factories and other targeted reductions consistent with lower volumes in 2023. In addition, we ceased production at our Shenzhen factory at the end of Q4 and will fully close the facility within the current quarter. Looking forward, we expect another $1 million to $2 million of restructuring in Q1. As a combination of these actions and attrition, we expect total head count to be down approximately 10% by the end of 2023, mostly in our factory operations.

Our non-GAAP tax rate was 17%, driven by the level of annual earnings, geographic mix and true-ups to year-end tax positions. For 2023, we are modeling our GAAP and non-GAAP tax rate in the 18% to 19% range.

Fourth quarter EPS was $1.70, up from last year's EPS at $1.36 and down from the record third quarter EPS of $2.12.

Now, let me quickly touch on our full year results. In 2022, we delivered record revenue of $1.85 billion, which was up 27% year-over-year. Excluding the SL Power acquisition, organic revenue grew 23%. We achieved record revenues in the semiconductor, industrial and medical and data center computing markets. On the other hand, we paid over $100 million of material premiums to secure critical parts. Although we were able to recover a portion of these premiums from our customers, our gross margins were negatively impacted. Despite the sizeable cost, our 2022 non-GAAP earnings reached a record $6.49 per share, and our annualized second half earnings surpassed our EPS aspirational goal of $7.50.

Turning now to the balance sheet. Total cash and marketable securities at the end of the fourth quarter was $461 million, with net cash of $88 million. Cash flow from continuing operations was $71 million. Inventory days were 109 and turns improved to 3.3 times, up slightly from 3.2 times in Q3 as we began to consume inventories of non-critical parts. DSO ticked up slightly to 55 days and DPO declined to 49 days, down from 61 days last quarter, largely due to timing of purchases and lower inventory levels. As a result, net working capital increased to 115 days from 106 days last quarter.

During the fourth quarter, we invested $19 million in CapEx as we began to incur the cash expenditures for many of the infrastructure and capacity investments initiated earlier in the year. Looking forward, we expect CapEx to run approximately 4% of sales on timing of project completions and investments to optimize our footprint and scale our structure. During the quarter, we also made debt principal payments of $5 million, paid $3.8 million in dividends and repurchased approximately $700,000 of common stock at $69.16 per share.

Turning now to our guidance. Based on this decline in the wafer fab equipment market, we expect our semiconductor revenue to be down in the high-teens sequentially with the impact of the market decline partially mitigated by our pockets of strength and our ability to complete the restocking of customer inventories to normalized levels. While demand is stronger in our other markets, revenues continue to be gated by supply of critical components. As a result, we expect first quarter revenue to be approximately $415 million plus or minus $20 million.

We expect Q1 gross margins to be in the low 36% range on lower volumes and modest improvement in material cost premiums. We expect Q1 operating expenses to be down slightly from Q4, but to increase modestly for the balance of the year on inflationary factors and continued investment in critical R&D and growth initiatives. As a result, we expect Q1 non-GAAP earnings per share to be a $1.10 plus or minus $0.25.

Before I open it up for questions, I want to highlight a few important points. 2022 was a record year for Advanced Energy. Our semiconductor revenue growth substantially outperformed the wafer fab equipment market, and each of our end markets grew 20% or more year-over-year. While this will inevitably result in tougher comparisons in 2023, we continue to expect to perform better than the market over the course of the year. More importantly, we believe our diversification into multiple markets, larger and more stable service business, and healthier backlog in customer inventory positions will enable us to perform substantially better than in previous market cycles, demonstrating the benefits of our long-term strategy.

While the supply chain remains dynamic, we expect improvement in deliveries of critical components over the course of the year, which coupled with lower material premiums and improved operational efficiency will allow us to gradually improve our gross margins in the second half of the year. During this time, we will continue to accelerate new products and scale the company, while controlling our discretionary spending and optimizing our footprint. As a result, we expect Advanced Energy is well positioned to outperform during this cycle, emerge stronger as markets recover and continue to grow revenue and earnings over time.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. We'll now be conducting a question-and-answer session. [Operator Instructions] Thank you. Our first question is from Quinn Bolton with Needham & Company. Please proceed with your question.

Quinn Bolton
Analyst, Needham & Co. LLC

Q

Hey, guys. Congratulations on the strong finish to 2022. I guess, maybe Paul or Steve, I guess kind of a big picture question. It sounds like margins are going to stay fairly flattish in the low 36% range in the first half of the year with only modest improvement expected in the second half of the year. I guess what do you think it takes to get back to the 40%, 41% gross margins envisioned by the aspirational model?

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

A

Yeah. It's a good question. I'll take that one, Quinn. So, clearly in the near term, we continue to be impacted by higher material costs, and we expect those to begin to abate largely in the second half. We'll still see those through the first half, just given the timing of these costs going through our inventories. Now, we do expect to see gross margins start to pick up– later in the year, which will give us some improvement certainly as we have an exit rate to 2023. But the offset to that is we're not anticipating any pickup in volumes from these levels. In fact, our second quarter may even be down a little bit from this quarter as we won't get some of the restocking shipments we expect in the first quarter.

So based on that, we'll see headwinds from volumes. But as volumes begin to recover and as the actions that we are taking over the course of the year to optimize our footprint, take hold, then we expect that we'll be back on that track to get back to 40% or greater.

Quinn Bolton
Analyst, Needham & Co. LLC

Q

Got it. And then I guess I think you kind of hinted at the answer to my next question, but just give us a sense where you are in terms of the [ph] jet bins (00:23:20), it sounds like you had an opportunity to begin restocking those in the fourth quarter, and you expect to restock perhaps more in the first quarter. But it sounds like – am I right to assume that by the end of the March quarter you're probably back to normal levels in terms of [ph] jet bins (00:23:40) or inventory levels at your semiconductor customers?

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

A

Yeah. That's right. We definitely saw some benefit of that in the fourth quarter. And as I said in my comments, we've been able to largely restock those. Now, there's a little more to go. So we'll get a little more benefit in the first quarter, but we anticipate that that will be – customers will have the inventories they would like on their shelves by the end of the first quarter.

Quinn Bolton
Analyst, Needham & Co. LLC

Q

Got it. Okay. Thank you.

Operator: Thank you. Our next question is from Scott Graham with Loop Capital Markets. Please proceed with your question.

Scott Graham
Analyst, Loop Capital Markets LLC

Q

I am here. I'm sorry. Little technical issue.

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

A

Hey, Scott.

Scott Graham
Analyst, Loop Capital Markets LLC

Q

Hey. Same thing. Congrats on a good finish to the year and a good evening. Couple of questions. So, you're looking – the backlog where it is and you're looking to bring that to, I think you said – you either said to $400 million to $500 million or down – I think you meant – maybe I misunderstood down by $400 million to $500 million. Could you – how does that play out? I'm sorry. I just missed that when you said it.

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

A

Yeah, no worries. We expect that backlog we'd like to bring it to about $400 million to $500 million. We think that's a reasonable target level. That would actually be probably a little more than historical levels. But just given the nature of the markets of these days, we think that's a more normalized levels. And as we said, we expect that to happen over the next several quarters. We continue to have a very healthy backlog. As we mentioned, our non-semiconductor backlog actually increased for industrial and medical and was about flat for the others. So it's actually – continues to be an opportunity for us as we get some of the critical or scarce parts in to be able to bring in our lead times, bring that backlog into more normalized levels, and we expect that will happen over the next several quarters.

Scott Graham
Analyst, Loop Capital Markets LLC

Q

Thank you. And then can you just remind me the – or maybe just tell us the $875 million, how does that split by business?

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

A

Yeah, we haven't historically broken that out, but as I mentioned, the backlog reduction this time was largely concentrated or entirely concentrated in semiconductor in part because we removed some backlog out of our reported backlog, the China orders, that was about 40% and the rest was really about rebalancing in our semiconductor markets. We were able to fill in some of the [ph] bins (00:26:27), as I mentioned in my earlier question. We've been able to bring our lead times down. And, of course, our customers have reacted to the lower demand environment and brought their orders down.

So if you look outside of semi, our backlog was about flat from last quarter, reflecting really stronger demand across those markets and continues to represent an opportunity for us to bring that more in line and either buffer lower demands if that happens in the future or deliver some upside, if we can get additional parts as we go forward. But our goal would clearly be to try to bring that backlog and therefore our lead times more in line with that $400 million to $500 million target.

Scott Graham
Analyst, Loop Capital Markets LLC

Q

I got you. And then last one from me. Just a quickie. The gross margin guide for the first quarter, low 36s. I'm surprised you didn't mention mix as one of the key components of the delta. Where does mix fall in that?

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

A

I think mix does have some impact certainly as we go from the second – from the fourth quarter to the first quarter. But if you look at overall sort of the combination of the actions we're taking, a little bit fewer of the PPV recoveries we still expect of higher material cost, but less recoveries, those things tend to – are kind of tending, and the actions, like I said, we're taking are kind of offsetting the impact of the lower volumes overall. So, net-net, we expect to be down a little bit. It's actually, we think, pretty good from a delever perspective, and the hold margins, I'll say, down a little bit or down to flat. And it's a function of the actions we're taking and some improvement in material costs offsetting the other items.

As we think as we look forward, we think we can probably hold gross margins and trough margins around 36%, I'll say, plus or minus depending on volumes and where the markets go. But that's kind of how we're thinking about it. And as was asked earlier by Quinn, particularly in the second half, as these material costs subside, the full impact of the actions we're taking to optimize our factory footprints, those should help to see a little margin improvement in the back half of the year, but really positioned us in 2024 to see either continued margin improvements at sort of these similar lower levels, or if we see revenues pick up a little bit, be able to kind of accelerate back towards our 40% target.

Scott Graham
Analyst, Loop Capital Markets LLC

Q

That's great color. Thanks.

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

A

Yeah.

Operator: Thank you. Our next question is from Krish Sankar with Cowen and Company. Please proceed with your question.

Krish Sankar
Analyst, Cowen and Company

Q

Yeah. Hi. Thanks for taking my question. I had a couple of them too. Paul, just to follow up on your earlier comments, you mentioned second half gross margins should improve and some of these cost reduction and other factors should offset volume declines. I'm kind of curious, what is your visibility today? Because if I try to triangulate your answers, it seems to me that the brunt of the revenue decline happens in the first half and it kind of starts bottoming in Q2 or Q3 on a sequential basis and improves into Q4. Is that the way to think about linearity of revenues this year?

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

A

Yeah. We have to – obviously, we're operating in this market where semi is down this coming year. But as we look at overall, we expect semi to be down and we expect our other markets to be generally about flat or relatively stable overall. And so from an operating perspective, that way we're planning is you're right, we expect most of the brunt to be here in the first quarter, perhaps a little more in the second quarter, particularly, as we won't have the benefit of the inventory stocking on the semiconductor side and it kind of bounces around those levels for the balance of the year. I think that's generally consistent with how people see the market right now. Obviously, it's hard to look out that far and know for sure, but that's our operating assumption. And the gross margin color I gave sort of reflects that type of a revenue projection.

Krish Sankar
Analyst, Cowen and Company

Q

Got it. Got it. Then I had two other questions. One is obviously last year you guys just did really well outperforming WFE. Typically, component companies tend to underperform WFE during down years. So I'm just kind of curious if you think WFE is down, pick a number, 20% or 25%, how to think about your semi revenues relative to where WFE ends up this year? Would you be in line versus better than that. And then I had a quick follow-up?

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

A

Hey, Krish. I'll jump in here. Thanks. We should talk about is the fact that AE now is 50% non-semi as well as 50% semiconductor revenue. As we said before, we think that the non-semiconductor revenue, we could hold that flattish year-on-year. So that's quite a cushion for us compared to past semiconductor downturns. And within semiconductor, we think we do have pockets of strength. Our service business is much larger and stronger than it's been in past downturns. We've got a very good position in ion implant. And as you know, there's still a lot of demand for ion implant that's out there as people try to address the power IC shortage. And then we've got a number of new product ramps that are happening across the application set in semiconductors, which serve to offset to a certain extent some of the downdraft in semiconductor.

Krish Sankar
Analyst, Cowen and Company

Q

Got it. Got it. Thanks, Steve, for that. And then just a final follow-up on the backlog. I think Paul, you mentioned normalized backlog of $400 million to $500 million. Is this fair to assume you probably get to those levels in a couple of quarters, if revenues continue to decline? And at that level, is it roughly a 50/50 mix of semi and non-semi?

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

A

I don't know how long it takes. It kind of depends on the demand environment. But we've already seen sort of, I'll say, a pretty good reset of the semi backlog this quarter. We took out the China demand and we've adjusted that basically to our customers' outlook at this point. So if the balance, if you think about where the most of the rest of backlog is in our industrial and medical areas, which I said, despite kind of, again, near-record shipments, that [ph] ion imp (00:33:00) backlog was up again this quarter.

So it depends a bit of a function on at the demand, how well the demand for these other markets continues. We think that looks relatively stable, all things considered. And then our ability to solve critical parts and actually eat into that backlog and bring our lead times down. So that's a little bit how we think of it. My sense is it will take a few quarters to roll that down. I doubt that that's going to get to our target range in a quarter or two.

Krish Sankar
Analyst, Cowen and Company
Q

All right. Thanks a lot, Paul. Thanks, Steve.

Operator: Thank you. Our next question is from Atif Malik with Citi. Please proceed with your question.

Atif Malik
Analyst, Citigroup Global Markets, Inc.
Q

Hi. Thanks for taking my questions and nice execution. First, Steve, if you can talk about what you're seeing on the data center market and maybe if you have color enterprise versus cloud, we have been hearing about moderation in that market. Your comments on backlog indicate that you're seeing a stability in that market. So what are you seeing in the data center market?

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

Yeah, it's interesting. We obviously have strong participation in that market. I could say that we have not seen major changes in demand. In fact, we're still supply constrained in that market, and our customers in the hyperscale market are constrained by power supply manufacturers like us, quite frankly. So what we're seeing is continued pull from the customers, but we're also seeing a transition happening and it's moving in our favor basically. We see the move to 48 volts. It's starting to accelerate and we are the leader there. We were the first and we sold the best technology for 48-volt type hyperscale applications. We see a strong move to higher efficiency, as the cost of electricity go up and the environmental concerns become more prominent. We're in a good position because we have the most efficient solutions.

And finally, we see a strong move to artificial intelligence, which increases GPU and memory intensity, and it really places a premium on power density. And that's also an area where we excel. So I think over the medium to long term, we're well-positioned to gain share because these technology advantages we have. In the short-term, we see demand still being pretty strong but guided by component availability.

Atif Malik
Analyst, Citigroup Global Markets, Inc.
Q

Great. And a follow-up for Paul, if you can touch on restructuring and are there opportunities for fixed asset optimization as you guys head into a downturn and eventually come out other areas where you can prune some products or businesses to lift up the gross margin? Thank you.

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

A

Sure. So as we announced a plan for restructuring, this is largely around optimizing our footprint and a few targeted reductions around the company. We do think that our goal as part of this isn't just to try to match head count to some level of production or output, but is actually to improve our footprint. So we want to move products from some of our smaller factories and leverage those around our larger factories. There's areas where we're going to make some investments. As Steve mentioned, we'll expand our newly acquired footprint in Mexico because we think that's an attractive place and gives us some strategic benefit in North America. And our larger factories will continue to optimize those around efficiency and capability.

So we would expect to come out of this with, I'll say, maybe a little bit smaller footprint, certainly from a head count perspective, but a more efficient one and an ability to scale better as we move into the next upturn.

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

A

And just to address your question about exiting businesses, we have no intention of exiting any business. And we had some concerns about the computing and networking businesses a couple of years ago. And I could say we've done a really good job improving the bottom line performance there. So I'm much less concerned than it was two years ago. We've also done a good job refocusing our resources on proprietary opportunities within those market spaces. And so between a better job managing our pricing tactically and a better job focusing on higher-value opportunities, I think that business is looking much better.

Atif Malik
Analyst, Citigroup Global Markets, Inc.

Q

Thanks, Steve.

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

A

You're welcome.

Operator: Thank you. Our next question is from Steve Barger with KeyBanc Capital Markets. Please proceed with your question.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

Q

Thanks. For the expected acceleration of new product wins and design wins this year, do you expect more traction from modified standards or full custom solutions? And can you talk about how those compare just from a time to market and margin perspective?

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

A

Yeah, Steve. I think it's a combination of both, quite frankly. The important thing is that we're introducing a lot more new platforms that's across semiconductor, industrial and medical, as well as in the high-volume areas like data center. And what happens with those new platforms, it goes one or two ways. The customer will say, hey, this meets our needs, but I need a few changes and that's a modified standard. Or the customer will say, you know, you're pretty close, but I need some significant changes, and I leverage what you have, I need this other feature as well. That's more of a custom product. But either way, we're happy with it because at the end of the day, ends up being a sole source product and a source of revenue for many years to come.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

Q

Is there a big difference in dollars and margin between the two?

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

A

Not really. So the full custom products tend to go to a large customer, so they're higher volume typically. So they require more engineering investment upfront. But then the volumes and the dollars would be higher with those types of products. The modified standards tend to be more towards small and medium sized customers. The engineering effort is much less, but the gross margin percentage for both of those products is similar.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

Q

Got it. And you said there's a strong network of distributors and value-added resellers. Are you fully covered in those channels, especially in the newer markets, medical and industrial, in terms of geographies and can you talk about the mix impact of having more product go through those channels versus direct sales?

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

A

Yeah. If I look at our position relative to our competitors, I think we have more of a worldwide footprint than most. So we have strong organizations in Asia, Europe and North America. That said, there's a lot of improvements we can make and we're doing that. And so, we've held sales conferences in the past year in all regions and really tried to align our internal sales teams with our external partners and make a much more concerted effort trying to penetrate industrial and medical customers. So I have high hopes that we could do a lot better this year and in 2024.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

Q

Understood. Thanks.

Operator: [Operator Instructions] Our next question is from Pavel Molchanov with Raymond James. Please proceed with your question.

Pavel Molchanov
Analyst, Raymond James & Associates, Inc.

Q

Thanks for taking the question. Given the macro headwinds on the demand side that you've outlined today, I'm curious if the M&A landscape in terms of the kind of prospective target rich environment is perhaps offering better opportunities now than it was in happier times 12 or 18 months ago.

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

A

Yeah. I'll take that one, Pavel. We think the environment today for strategic buyers is better than it was last year or in 2021. So that's a positive. I think many of the companies operating in our space have been handicapped in the past two years due to the part shortages. And so I think some of those shortages are starting to go away. And I think they're probably going to realize this is about as good as they're going to get, right. So there's some demand challenges. But the financial performance they come up with in 2022 will lead to, I think, more reasonable valuations as we engage with those targets. So, yeah, the bottom line answer to your question is I think it's a more favorable environment and we'll take advantage of that.

Pavel Molchanov
Analyst, Raymond James & Associates, Inc.

Q

And from a balance sheet perspective, I think the last two quarters you had kind of de minimis share buyback and not much M&A recently. So you'll be pretty soon in a sizeable net cash position. What are your thoughts on kind of openness to lever off the balance sheet, if needed for the right opportunity?

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

A

Yeah, you're right, Pavel. We have a good balance sheet. We have net cash again after a brief time when we were about cash and debt equal. And we should generate cash during the downturn here. And we're fortunate that we have a very good credit agreement in place that's relatively low cost that we can extend either through a line of credit or through some accordion features that are within it. So I think we have capacity, if we saw the right opportunity to be able to use both our balance sheet and our credit position to make that acquisition.

At the same time, we're going to balance make sure this is the right return. Money costs more these days and also ensure that we don't over-lever the company. So we in general have a target of not going beyond 3 times our leverage ratio. And so we would manage all those things to make sure that we add value to any M&A that we did.

Pavel Molchanov
Analyst, Raymond James & Associates, Inc.

Q

And then just lastly, a quick point of clarification with the shutdown of Shenzhen, what is the manufacturing footprint of the company right now?

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

A

Yes. Really, three main areas where we have large factories, we still have one in China. We now have a large and very good factory in Malaysia and we have footprint in the Philippines. We also have a handful of, we call them kind of, boutique factories in different places aligned with local engineering teams for some of the acquisitions we've done over time.

Pavel Molchanov
Analyst, Raymond James & Associates, Inc.

Q

All right. Very clear. Thank you, guys.

Operator: [Operator Instructions] Thank you. There are no further questions at this time. This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.