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Advanced Energy Industries, Inc. (AEIS)

Q1 2023 Earnings Call

CORPORATE PARTICIPANTS

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Paul R. Oldham
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OTHER PARTICIPANTS

Quinn Bolton
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Krish Sankar
Analyst, TD Cowen

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Greetings, and welcome to the Advanced Energy First Quarter 2023 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, sir. 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 Q1 2023 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 in 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, May 4, 2023, and the company assumes no obligation to update them. Any targets beyond the current quarter presented today should not be interpreted as guidance.

On today's call, our financial results are presented on a non-GAAP financial basis unless otherwise specified. Excluded from our non-GAAP results are stock compensation, amortization, acquisition-related costs, facility expansion and related costs, restructuring charges and unrealized foreign exchange gains or losses. A detailed reconciliation between GAAP and non-GAAP measures can be found in today's press release.

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

Stephen Douglas Kelley

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

Thanks, Edwin. Good afternoon, everyone. Thanks for joining the call. First quarter revenue and earnings per share exceeded our guidance. Strength the industrial medical market as well as improved component supply drove year-on-year revenue growth of 7%. Our operations team executed well, quickly turning critical components into revenue late in the quarter.

Moving forward, we believe that 2023 will be a pivotal year for the company. The easing of supply chain bottlenecks means that our customers are now squarely focused on new product development and product differentiation. The timing is perfect for us since we have recently launched a number of innovative new products with highly differentiated capabilities. We are expecting a record number of design wins in 2023, laying a strong foundation for profitable revenue growth. We believe that technology leadership coupled with superior operational performance is the recipe for success in our business.

Over the past 18 months, we have made substantial strides towards best-in-class operational performance, particularly in the semiconductor space. We see further room for improvement and are taking advantage of the 2023 market environment to focus on operational efficiency. We are accelerating the consolidation of our factory footprint, which will improve productivity and lower fixed costs.

As part of that consolidation plan, we will expand our factory in Mexicali where we expect to quadruple output over the next two to three years. Our enhanced capabilities in North America will complement our strong factory network in Southeast Asia.

Now, I'd like to provide an update on supply chain. The overall supply situation continues to improve. However, shortages of power MOSFETs and certain older node ICs continue to constrain shipments into many of our markets. We expect these constraints to be largely resolved by the end of the year, allowing us to clear most of the remaining overdue backlog. This is a high priority for the company since resolving the remaining constraints will drive higher revenue, reduce inventory and improve customer satisfaction.

I'll now provide more detail for each of our markets. As expected, first quarter semiconductor revenue declined sequentially. Record service revenue offset some of the weakness in the broader market. On the product revenue side, there were two bright spots. The first was ion implant applications, where demand for Advanced Energy's high voltage systems is extremely robust. The second was ramping design wins in the etch and deposition areas.

In addition, we began shipping beta units of two new plasma power products to our customers. We believe that these highly differentiated platform products offer best-in-class power control to our customers who are developing next generation plasma etch and deposition systems. We expect to close design wins for these new products in the coming year. These wins should drive meaningful market share gains over the course of this decade. We plan to formally launch these new platform products at SEMICON West, where we will provide more details on their impressive capabilities.

Moving on to industrial and medical. First quarter revenue grew 48% year-on-year to $123 million, a new record for the company. The upside was driven by improved component availability and solid demand. In the industrial space, demand in thin film manufacturing applications was very strong. In the first quarter, we also secured industrial design wins in test and measurement, manufacturing equipment and 3D printing applications. In medical, we won designs in electrosurgery, life science, imaging and laser applications.

We are also benefiting from new cross-selling opportunities made possible by last year's acquisition of SL Power. Many SL Power customers are now evaluating in designing in medical products from other parts of our portfolio and vice versa. We continue to invest heavily in dedicated engineering and customer facing resources for the industrial and medical market. We believe that Advanced Energy provides a unique bundle of technology, financial strength, operational expertise, staying power and technical support, which will drive share gains in this broad market.

In datacenter computing, first quarter revenue declined to $60 million, mainly due to component shortages. We also saw reduced demand from some hyperscale customers. Moving forward, we believe that there is upside in this market as the component shortages are resolved. In addition, we are continuing to focus our engineering team on high value opportunities. In telecom and networking, revenue grew sequentially and year-on-year to $8 million, largely due to improved component availability.

Now let me summarize the quarter and our outlook. The first quarter results validate the benefits of our diversification strategy as we performed above expectations despite the semiconductor market correction. We executed well and delivered upside to our financial targets. At the same time, we are taking actions to control our costs and accelerate the consolidation of our manufacturing footprint.

For the full year, we believe that our semiconductor business will perform better than the market due to several pockets of strength. Outside of semiconductor, component shortages are still gating our revenue but we expect that most shortages will be resolved by the end of this year. Therefore, we remain confident that our aggregate revenue in markets outside of semiconductor will be stable year-on-year.

Looking beyond this year, we are encouraged by the strong customer interest in our new product. We believe that technology leadership, coupled with solid operational performance, will drive strong customer engagement levels with Advanced Energy. Ultimately, these engagements will drive long-term profitable growth and increase value for shareholders.

Paul will now provide more detailed financial information.

Paul R. Oldham

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

Thank you, Steve. Good afternoon, everyone. First quarter revenue of $425 million and EPS of $1.24 both exceeded the midpoint of our guidance, reflecting solid operational execution. Revenue grew 7% year-over-year and 3% organically, with record revenue in the industrial medical market, partially offsetting the anticipated weakness in semiconductor. Our backlog exiting the quarter was $756 million, down 14% from $875 million at the end of the fourth quarter. The sequential decline was driven primarily by customers reducing orders or out quarter deliveries as we improved our lead times. As we further resolve critical part issues, we continue to expect our backlog will normalize to a level of $400 million to $500 million over the next few quarters.

Now let's review our financial results in more detail. Revenue in the semiconductor market was $194 million, down 4% year-over-year and 16% sequentially. The sequential decline was slightly better than our guidance as we delivered record revenue in our service business, executed to meet higher demand for ion implant applications and completed restocking of customer inventories back to targeted levels. Revenue in the industrial medical market was a record $123 million, up 48% year-over-year and up 3% from last quarter.

Excluding the SL Power acquisition, organic revenue grew 31% from last year and 8% sequentially. We delivered a record quarter despite continued constraints of select components for this market. Datacenter computing revenue was down 22% year-over-year and 37% sequentially to $60 million. Although we saw lower demand from some hyperscale customers, revenue was primarily impacted by supply chain challenges as we saw backlog actually increase in the quarter for these products. As a result, we expect revenue to increase from this trough level over the next few quarters as parts availability improves. Telecom and networking revenue was up 36% year-over-year and 8% sequentially to $48 million. It was one of the strongest quarters in recent history as we were able to secure more parts to meet demand.

First quarter gross margin was 36.8%, up 20 basis points from last year and last quarter. Gross margin remained relatively flat sequentially, despite the impact of lower volume as a result of modest reduction in material premiums, favorable mix and initial actions we are taking to optimize our factory footprint and reduce costs. While we expect higher material costs to continue to negatively impact our results, we're encouraged by early signs of a loosening in the supply chain. As a result, we continue to expect gradual improvement in gross margin towards the end of the year as premiums abate and historical costs flow through our inventory.

Operating expenses were $99.7 million, down slightly from last quarter on reduced [indiscernible] (00:12:50) partially offset by higher R&D investments driven by new product and platform launches expected this year. Operating margin for the quarter was 13.4%. Depreciation was $9.5 million and our adjusted EBITDA was $66 million. Non-GAAP other income was a positive $500,000 due to higher net interest income, partially offset by foreign exchange losses. Going forward, we expect our non-GAAP other income to be about breakeven as we continue to benefit from higher interest earnings in the current environment and our low-cost debt structure.

Last quarter, we initiated our 2023 restructuring plan to optimize our manufacturing operations and achieve other targeted reductions consistent with the current environment. During the first quarter, we completed the closure of our Shenzhen facility, reduced our total head count in operations by over 800 people, announced plans to close an additional factory in China and initiated further actions across the company. As a result, we recognized a further $1 million in restructuring costs in Q1 and expect to incur an additional $3 million to $5 million over the remainder of 2023. Rounding out the P&L, our non-GAAP tax rate was 18.1%. For 2023, we are modeling our GAAP and non-GAAP tax rate to remain in the 18% to 19% range. As a result, first quarter EPS was $1.24, which was flat from last year and down from $1.70 in the previous quarter.

Turning now to the balance sheet. Total cash and marketable securities at the end of the first quarter were $462 million, with net cash of $93 million. Cash flow from continuing operations was $32 million compared to $10 million last year. Inventory increased $26 million or 7% sequentially on higher raw materials as a result of lower revenue and increased finished goods on timing of customer shipments. We expect these finished goods to largely ship through in the second quarter. As a result, inventory days were 135 and turns decreased from 3.3 in Q4 to 2.7 in Q1. We saw a corresponding increase in DPO, which increased to 62 days. DSO was also up slightly to 62 days on timing of customer shipments late in the quarter.

During the first quarter, we invested $16 million in CapEx, slightly below our expectation for 2023 of approximately 4% of sales. We also made debt principal payments of $5 million and paid $3.8 million in dividends.

Turning now to our guidance. The demand environment continues to be mixed across our markets. As we noted last quarter, we expect our semiconductor revenue to decline again in the second quarter in the mid-teens sequentially. At the same time, we expect Q2 semi revenues to be the trough for the year with second half revenue being flat to up versus the first half. In our other markets, we expect revenue in aggregate to grow sequentially in Q2 as we secure additional critical components. As a result, we are forecasting our second quarter revenue to be approximately $410 million plus or minus $20 million. We expect gross margin in Q2 to be in the low 36% range on anticipated mix and lower volumes partially offset by a modest improvement in material cost premiums. We expect gross margins to remain at or above this level in the second half of the year.

As we stated last quarter, we expect Q2 operating expenses to increase $2 million to $3 million sequentially due to annual salary changes, inflation, and continued R&D investment. However, we anticipate OpEx to moderate slightly in the second half of the year as we see the benefits of our actions to control spending while maintaining investment in critical R&D and growth initiatives. As a result, we expect Q2 non-GAAP earnings per share to be $1 plus or minus $0.25.

Before I open it up for questions, I want to highlight a few important points. First, our diversification strategy is working. Record revenue in our industrial and medical market and solid demand across most of our non-semi markets partially offset the anticipated weakness in the semiconductor market. As a result, we were able to deliver year-on-year revenue growth for the first quarter.

Second, as component availability gradually improves, we are well-positioned to improve gross margins as we exit the year, enabling more meaningful leverage in our model in 2024. Lastly, we believe our strong cadence of new products will lead to more business for Advanced Energy over time, enabling us to grow share and exit the downturn stronger. As a result, we continue to believe we are well-positioned to perform better than our markets this year, deliver results substantially better than in previous cycles, and to gain share and grow earnings as the markets improve.

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

QUESTION AND ANSWER SECTION

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

Quinn Bolton
Analyst, Needham & Co. LLC

Q

Hey, guys, can you hear me now?

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

A

Yeah, we can hear you.

Quinn Bolton
Analyst, Needham & Co. LLC

Q

Yeah. Okay. Sorry. I was on mute. I just want to say congratulations on the nice results. Wanted to start with the industrial and medical business, which looks like it's very strong, especially on a year-over-year basis. Can you just give us some more color about some of the drivers for that business both in the near term? And based on your current backlog, how sustainable do you think this industrial demand will be this year?

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

A

Yeah. Thanks, Quinn. This is Steve. Yeah. We're very enthusiastic about the industrial medical part of our business. We started really focusing on industrial medical over the past year and a half. So we've put a lot of new engineers in place to develop products faster. We also reorganized our sales force to call them more industrial medical accounts directly. So we're seeing the results of that in record design win activity. And also we're seeing quite a bit of cross-selling activity in the medical space based on our purchase of SL Power about one year ago.

I think the nice thing about I&M, industrial and medical, is that it's very broad-based. So even though one segment may be down, another part of that market could be up. So it tends to be pretty stable. Right now we have a significant industrial medical backlog which is overdue. So we believe over the next couple of quarters we'll be able to ship more of that overdue backlog based on increased availability of parts. So we're very optimistic about that part of our business in 2023.

Quinn Bolton
Analyst, Needham & Co. LLC

Q

Excellent. And then for Paul, I guess just a question on the material cost headwinds to gross margin. Are they still in the sort of 250- to 300-basis-point range? Is that the right kind of headwind to be thinking about?

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

A

Yeah, Quinn. I think certainly we've seen a little bit of improvement on that front. When we look at it this quarter, it's probably in the 150 to 200 basis points if you look at the absolute number. Part of that is captured in inventory so it will flow through – part of that lower number is captured inventory, so it'll flow through over the next quarter or so. But it seems to be – early sign is it seems to be coming down. Our best view continues to be what we said last quarter is that we expect that these costs will continue to abate over the course of the quarter. And we should be able to exit the year hopefully at a place where we're seeing most of these costs working their way out of our P&L.

Quinn Bolton
Analyst, Needham & Co. LLC

Q

Perfect. Thank you.

Operator: Our next question comes from Krish Sankar with TD Cowen. Please proceed with your question.

Krish Sankar
Analyst, TD Cowen

Q

Yeah. Hi. Thanks for taking my question. I had a couple of them. First one is actually a two-part question both for you, Steve and Paul. First part is they spoke about Chinese revenues troughing in Q2 and then improving. I'm just kind of curious what gives you the confidence.

And the second part of that question is, last quarter, if I remember, there's probably $85 million to $90 million from backlog that got removed because of the China export controls. But some of the customers spoke about shipping back to some of the lagging memory Chinese customers. So I'm kind of curious how to think about how much of that backlog comes back into your backlog. And is that part of the reason why you feel comfortable about the second half revenue improving? And then I have a follow-up.

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

A

Hey, Krish. This is Steve. I assume we're talking just about the semiconductor part of our backlog. Is that correct?

Krish Sankar
Analyst, TD Cowen

Q

Yes. Yes.

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

A

Okay. Yeah. So we do believe the second half will be stronger than second quarter. And so we're bullish on that because we've seen the backlog increase. And I think part of that increase is due to some of the clarifications that our customers have received about shipping into China. So we've seen some strengthening in the backlog in the second half.

I think the other part of it is we do see our continuing pockets of strength will be benefiting us in the second half as well as the first half. We talked about our service business. The other one that's very exciting for us is the high voltage business and as the demand for ion implant applications is very strong and that's being led by the expansions in capacity for silicon carbide and other power type processors.

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

A

Yeah. Krish, I think the other factor is, we expect Q2 is kind of our trough because we've completed, basically the selling of inventory to our customers, which has helped us frankly the last two quarters kind of buffer the lower market conditions. So we think that's largely washed through. And as we look at the second half, our customers are talking about stronger trailing edge and them selling into China, which we believe will benefit us as well.

Krish Sankar
Analyst, TD Cowen

Q

Got it. And is there a way to quantify how much of that $85 million to $90 million backlog got removed because of China getting back in?

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

A

Yeah. We haven't quantified that publicly at this point. What we've put in the backlog at this point, I'd say, is quite limited, where we have direct line of sight to customers that we have a verification process in place to ensure that going to any leading edge application. So it's pretty limited at this point and I suspect it will kind of drop in a little bit over time as we're able to make sure we have good visibility to where product's going.

Krish Sankar
Analyst, TD Cowen

Q

Got it, got it. Thanks for the color, Steve. And then just as a follow-up on supply chain, you kind of mentioned there are still constraints on the MOSFETs and power ICs, which should probably abate by the end of the year. I'm kind of curious, like we've kind of been like two years or a little more two years into the states and it doesn't seem like your customers are having that issue of component constraints but you're still having it. I'm just curious like is that specific to just those few semiconductor devices and that is impacting and does it mean that you have to figure out whether to ship it to semi customers, I&M customers, hyperscalers or is there something else that's going on that in general because it seems like semi industry is going through a cyclical downturn. So I'm just kind of curious and people are all building capacity, yet here we are two years later talking about supply constraints.

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

A

Yeah. I think, Krish, it's a legitimate complaint. We want to do the same thing sometimes. But quite frankly, the list has narrowed considerably over the past two years, so it's a much more compact list. However, all it takes is one missing power MOSFET or one missing power IC and we can't ship the box. So we continue to compete with other industrial customers and automotive customers for trailing etch capacity, but based on what we're experiencing now, what we see in the second half we think that will be over most of these issues by the end of this year.

Krish Sankar
Analyst, TD Cowen

Q

Got it. Thanks a lot, Steve. Appreciate it. Thanks.

Operator: Our next question comes from Steve Barger with KeyBanc. Please proceed with your question.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

Q

Hey. Thanks. Steve, I know driving strong customer engagement is a priority for the year and I think you're focused on small and medium-sized customers because of the growth rates. First, how are you measuring engagement? Is it just having a dialogue? Is it based on actual sales conversion? What metric are you managing to there to drive that?

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

A

Yeah. Good question, Steve. And I think about that in two ways. One is customer pull for new products and with our large semiconductor customers, like I said, they're fully engaged with the two new platforms I've discussed earlier in the call. These are technology-leading products, and the customer pull is equal to the supplier push, which is always nice to see.

I think in the larger markets, what I've seen is with our increased rate of new product launches show a lot of excitement in the field around the world actually. And we measure that every month in our design win funnel and so we basically look at all the opportunities that are out there that we're trying to close. And right now our closure rate is approaching 40%, which is pretty good in my experience. So the number is high and the closure rate is excellent, so that's how I measure customer engagement.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

Q

And when you think about that 40% closure rate, is the pool of potential touch points growing in every quarter so that that 40% part of the pie is on a growing pie on a consistent basis?

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

A

Yes, it's a growing pie because in the past we have not focused on industrial medical counts. So just in the past year and a half, I think we've done some significant things and probably the most significant thing is going half our sales force on industrial medical design wins in revenue. And so they're very incented to go after new opportunities in small and medium sized accounts. It's a really great investment for us because generally speaking these design wins, although they're smaller, they tend to last a long time and they tend to be sole source. And so it's a nice market for us. And it's one of the three markets we really focus in on semiconductor, industrial and medical.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

Q

Yeah. And just one follow-up on that. Given the size of the industrial medical opportunity and your focus on it, how are you thinking about organic growth for that segment on a normalized basis? I mean, through cycles, can it be a double-digit grower on a regular basis and over time, can it catch up to semi equipment in terms of size?

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

A

We haven't articulated the specific growth metrics, Steve, but I've got very high hopes of business. We think it's an excellent business to be in, it buffer us during these semiconductor downturns, which will continue to happen moving forward. And we're seeing some of the benefits of that strategy this year. So I anticipate the industrial medical business will continue to grow. We have a lot of room to grow in that space and with a little focus in energy, I don't see a problem doing that.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

Q

Great. Thank you.

Operator: [Operator Instructions] We have reached the end of our question-and-answer session. This concludes today's conference. Thank you for your participation. You may disconnect your lines at this time.