Advanced Energy (Special Call)

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Corporate Speakers:

- Yeuk-Fai Mok, Advanced Energy Industries, Inc., VP of Strategic Marketing & IR
- Yuval Wasserman, Advanced Energy Industries, Inc., President, CEO & Director
- Paul R. Oldham, Advanced Energy Industries, Inc., EVP & CFO

Participants:

- Mehdi Hosseini, Susquehanna Financial Group, LLLP, Analyst
- Quinn Bolton, Needham & Company, LLC, Analyst
- Pavel S. Molchanov, Raymond James & Associates, Inc., Analyst
- Thomas Robert Diffely, D.A. Davidson & Co., Analyst

PRESENTATION

Operator: Welcome to the Advanced Energy to acquire Artesyn Embedded Power Conference Call.

(Operator Instructions)

I would like to turn the call over to Mr. Edwin Mok, Vice President of Strategic Marketing and Investor Relations. Sir, you may begin.

Yeuk-Fai Mok: Thank you, Victor. Good morning, everyone. Thank you for joining us on such a short notice. Welcome to our conference call discussing our agreement to acquire Artesyn Embedded Power, one of the world's largest providers of embedded power conversion technologies and products. If you have not seen the press release, you can find it on our website at IR.advanced-energy.com. There you'll also find a slide presentation to follow along our discussion during this call. With me today are Yuval Wasserman, our President and Chief Executive Officer; and Paul Oldham, our Executive Vice President and CFO, and Brian Smith, our Director of Investor Relations.

Before we began, let me remind you that today's call contains forward-looking statements which include the company's current views of our industry, performance, products, application and business outlook for both Advanced Energy and Artesyn Embedded Power. These statements are subject to risks and uncertainties that could cause actual results to differ materially and are not guarantees of future performance. Information contained on these risks and uncertainties is in our filings with the SEC and can be found in today's press release as well as our presentation. All forward-looking statements are based on management's estimates, projections and assumptions as of today May 15, 2019, and the company assumes no obligation to update them. In addition, long term targets or aspirational goals presented today should not be interpreted in any respect as guidance. Today's call also includes Advanced Energy's non-GAAP financial measures and Artesyn Embedded Power's adjusted financial measures and explanations of these measures can be found in our press release and presentation.

With that, let me pass the call to our President and Chief Executive Officer, Yuval Wasserman, to discuss this highly strategic acquisition. Yuval?

Yuval Wasserman: Thank you, Edwin. And good morning, everyone. Today we announce our agreement to acquire Artesyn Embedded Power business from Platinum equity for a total consideration of $400 million. With this acquisition, I believe we are beginning a new chapter in the execution of AE strategy. The addition of Artesyn EP transformed AE from predominantly semiconductor power company into a highly diversified industrial technology powerhouse, dramatically expands our presence in attractive industrial technology market and deliver significant value to our shareholders and stakeholders. On a pro forma basis AE instantly becomes a diversified premier power conversion company with $1.3 billion of sales and substantially expanded capabilities across critical power technologies and markets. Our addressable market will triple to $7.5 billion as we add multiple new and attractive growth market consisting of datacenters including hyperscale, telecom infrastructure in next generation 5G networks, embedded industrial power applications and medical power for diagnostic and treatment applications.

Artesyn EP is a solid strategic fit with AE. Our product portfolio and leading market positions are highly complementary and Artesyn EP shares many core competencies with AE. This acquisition is consistent with our strategy to deliver highly engineered, designed in power solutions for critical applications. At the same time it broadens and diversifies our market presence and customer concentration and provides a platform for AE to deliver a more stable growth. Finally, we are creating substantial financial value with this transaction. We expect to realize synergies that will drive projected annual earnings accretion of over $0.80 per share in the initial 18 to 24 months period. And over $1.50 per share long term on a non-GAAP basis. The deal is attractively priced with long term opportunities for margin expansion.

For those of you who are not familiar with Artesyn EP, it is one of the world's largest suppliers of power convergent technologies and products. Founded in 1968, Artesyn EP is well known as a leading supplier of highly engineered application specific power supplies used in demanding applications. It's macro drivers drives supporting growth in 2019 and future years. It has balanced presence across several growth industries, a diverse and global customer mix and a strong technical. In addition, Artesyn is well run operation with world class manufacturing capabilities and strong complementary distribution channels.

As slide 6 shows, Artesyn EP primarily serves three major end markets with its portfolio of AC and DC power supplies. It has deep customer relationships with many marquee names across these markets. In fact, 20 of Artesyn EP's customers are global Fortune 500 companies. Artesyn EP has a long history serving its key customers and it is viewed as a trusted technology partner.

Let me know discuss the many strategic benefits of this acquisitions. Artesyn's low voltage power technologies and portfolio products are a great match to AE's plasma generation and applied power solutions. Both companies have leading market positions across different industries with practically no overlap between our offerings in markets. With a global team of engineers and similar investment in innovation and product development and combined portfolio of over 600 patents, we will become an undisputed technology leader in power conversion and control.

Artesyn also have has a world class manufacturing operation, which will bring new capabilities to AE and provide opportunities for leverage in supply chain, cost improvement and factory utilization. In terms of the markets we serve, the addition of Artesyn EP triples AE's SAM to $7.5 billion and significantly diversify our markets and customer base. Beyond the addition of markets, both AE and Artesyn have products that we can cross sell into each other's respective markets. The acquisition will also reduce our customer concentration while allowing AE to better serve our most important customers with wider portfolio of offerings and more balanced and diversified AE will be a stronger platform to deliver stable growth going forward the new AE will have broad exposure to multiple macro growth drivers including datacenters, 5G wireless infrastructure, embedded power in industrial and medical and semiconductor equipment. The over arching scene between the market is a continued expansion of the data economy driving increased demand for more data processing, connectivity, intelligence and complexity across these verticals. In addition, each one of these verticals has its own unique growth drivers that will directly benefit the new AE. For example, power efficiency is becoming increasingly important in datacenters. And the adoption of intelligent power across industrial and medical applications is growing. With our strong technical capabilities, I believe AE will be well positioned to capitalize on these long term macro drivers.

Before I pass the call over to Paul to provide you with the financial details, I want to share our excitement and confidence in our ability to execute and deliver value to all of our stakeholders. To our customers in semiconductor and related markets, Artesyn EP brings new complementary products and leading technologies, a world class team and a manufacturing operation that will allow us to better serve you. To our employees, this acquisition opens new and exciting opportunities for growth and development. And finally to our shareholders, the 8 acquisitions we have completed over the last four years demonstrated that we can integrate and grow acquired businesses. While Artesyn EP is substantially larger than previous acquisitions, we are confident that we will be successful. We have a detailed integration plan, a team in place and the experience and financial resources that I know will make this highly successful and value creating acquisition. And with that, let me turn the call to Paul.

Yeuk-Fai Mok: Thank you, Yuval. And good morning, everyone. Please turn to Slide 10 in the presentation for an overview of this transaction. The total purchase price is $400 million, which includes approximately $364 million in cash and $36 million in assumed liabilities, all subject to a net working capital judgment at closing. It is important to note the purchase agreement only covers Artesyn's embedded power business including the Artesyn and Aztec brands. The agreement excludes Artesyn's embedded computing and consumer businesses, which will be separated from the company before the transaction is closed. We expect the close in the second half of this year subject to customary closing conditions and the completion of the carve out. We do not expect to be subject to U.S. HSR or China Sammer review. We'll be financing the transaction through a combination of a new five-year term loan of $350 million and cash from our balance sheet. In addition, we will renew but not draw on our $150 million line of credit, which provides us with further liquidity and financial flexibility. We believe that this transaction will create significant opportunity for synergies through sharing of manufacturing infrastructure, supply chain consolidation, portfolio optimization, leveraging an integrated sales platform, and consolidating administrative and corporate activity. For example, we expect to be able to combine China factory operations when our Shenzen lease expires in the next two years. In total, we expect to generate over $20 million in annualized synergies in the first 18 to 24 months and $40 million of annualized energies long term. In addition, given the cash flow generation of the combined companies, we will have significant deleveraging power, which will further accelerate earnings growth. Because Artesyn EP serves different end markets from AE, the business comes with lower growth and operating margins than our historical model. However, it is expected to be earnings accretive on a non-GAAP basis day 1, and gives us a platform for accelerated earnings growth both through its own earnings power and the synergies we described earlier. We have a well defined plan to improve margins for this business and over time we believe we'll be able to increase Artesyn EP's operating margins from mid single digits to low to low-mid teens. I want to know if we took a conservative approach when we created these models by not factoring in the expected incremental revenue synergies. As a result, we believe this acquisition will add incremental annualized earnings on a non-GAAP basis of over $0.80 per share in the initial 18 to 24-month period and over $1.50 per share long term.

Looking at slide 12, you can see the financial strength of the new company. On a pro forma combined basis based on 2018 results plus synergies, the company would generate high teens operating margins and EPS greater than $5.00 per share. Looking forward, we believe this acquisition provides us the platform to deliver accelerated revenue and earnings growth resulting in top quartile financial performance for diversified industrial technology company.

Our new long term aspirational goal is to deliver revenue of over $1.5 billion, combined operating margins greater than 20%, and achieve sustained double-digit earnings growth, resulting in earnings of over $6.50 per share.

Turning now to slide 13, to explain how we thought about value creation when we were evaluating this acquisition. First our team did a great job securing low cost debt financing to fund a majority of the cash outlay for this transaction. This lowers our cost of capital and leaves us with dry powder and flexibility to manage the business and to pursue our capital deployment strategy. Secondly, the deal is attractively priced at 0.7x last year's revenue and approximately 5x synergy adjusted EBITDA or 10x synergy adjusted net income. Looking forward, we expect Artesyn EP to grow this year, which will make the multiples even more attractive. Lastly, we compare the earnings accretion of this deal through repurchasing our own stock. Including anticipated near term synergies, we believe this transaction will be more than 2x more accretive then a share purchase of an equivalent size with additional upside as we achieve our long term goals.

Turning to our balance sheet, with the debt financing in place, we are also transforming our capital structure by adding leverage to the balance sheet, which will increase our financial scale and flexibility and at the same time reduce our (inaudible) capital. Our post deal growth and net leverage remain conservative at 1x gross leverage on a trailing 12-month basis. Based on the projected closing date in the second half, initial leverage could be slightly above 2x. However, looking forward, we will pivot our our future cash generation deployment toward debt reduction and delevering our balance sheet, which will enhance long term earnings growth while maintaining our abilities to deploy future cash toward capital return and potential future acquisitions.

In closing, I want to reiterate the key points of this acquisition. Artesyn EP substantially transforms AE into a highly diversified, premier power conversion company and triples AE's SAM by adding new and exciting growth verticals. We are requiring a complementary business in the area of highly engineered critical power applications to broaden our market presence and drive balanced revenue growth in new verticals. And we are creating substantial value by accelerating earnings growth both through Artesyn EP basis earnings power and the synergies of the combined company.

With that, let's open up the call for your questions. Victor?

QUESTIONS AND ANSWERS

Operator: (Operator Instructions)

And our first question comes line of Mehdi Hosseini from SIG.

Mehdi Hosseini: I apologize, joined a few minutes late, so you may have already answered this. But what kind of revenue was Artesyn generating over the past 12 months? And I have a follow up.

Yeuk-Fai Mok: Approximately $590 million if you look on a 12 month trailing basis.

Mehdi Hosseini: 502? I'm sorry.

Yuval Wasserman: 590.

Yeuk-Fai Mok: 590.

Mehdi Hosseini: Okay, got it. And then, as you try to integrate the company into your existing. How you're going to be recognizing or what is going to happen to the reporting? Because I'm looking at end market exposure they have industrial and also some exposure to semi? So you're going to cover that and be able to allocate your revenue segment? Or have you already break out your revenues?

Yeuk-Fai Mok: Yes, obviously with an acquisition this size, maybe we will provide visibility to this acquisition on a standalone basis for a period of time. As we look forward, we will look and integrate the company, we will look to provide reporting by end market that makes sense for people to understand on a revenue basis.

Operator: And our next question comes from the line of Quinn Bolton from Needham.

Quinn Bolton: Just wanted to ask just for the big picture. It would appear that the Artesyn business is much more of standards based, power supply, serving server, and telco markets, because it looks like it may be more standards based. You referenced a much lower gross margins and I thinking they come in at less than half of the gross margins for AE's traditional power supplies. Can you talk about some of the opportunities to potentially raise the gross margins for the Artesyn business whether that is through enhanced design or more efficient manufacturing? Where do you think that yes it is a standards based or more standards based solution and therefore will always carry meaningfully lower gross margins than your traditional business? And then I have a follow up, thanks.

Yeuk-Fai Mok: Sure, the first comment. We acquired the embedded power business of Artesyn and not the whole company. And the embedded power business is really a highly engineered set of products that are application specific and serve critical applications. This integration of this business will allow us to drive improvement on both the gross margins and operating income margins as well. Just a few examples, we believe that consolidation of the companies will allow us to reduce material costs by a bigger, broader supply chain and volume of material acquisitions. We believe the consolidation of our factories in China, which as Paul said, we are going to consolidate our Shenzen factory with Artesyn factory in China. That will increase factory utilization and will increase our dollar of revenue per square foot rent, right? In addition to that, Artesyn is a well run operation and the combination our operations strategy and their operations strategy, we believe will result in more efficient manufacturing process at the lower cost. On top of that, just like we did in other acquisitions in the past, we have now a very broad portfolio of products that we can take to our core market. As you know in the semiconductor industry, our main business is process power. We now have a very broad set of products that will allow us to enter the market of auxiliary power for the semiconductor wafer fabrication industry, which is sizable. So the combination of all that integration will -- we believe will allow us to improve both gross margins and operating income margins.

Quinn Bolton: The follow up question is just in the near term, two questions on the Artesyn business. You gave us the run rate for the 2018 revenue for that business. Clearly there's been slow down, as it is pretty well documented in the datacenter servers segment of the market wondering if the Artesyn embedded power supply businesses has seen that slow down effect, the revenue here at least in the near term, so I was just trying to think about what a quarterly run rate might be trending if the datacenter businesses is ? Second, you mentioned the Shenzen manufacturing facility for Artesyn. I assume that, that might currently be impacted by that tariff situation and did you have any thoughts on how tariff uncertainty maybe impacting that business in the near term?

Yeuk-Fai Mok: Yes, good question. First of all, on the revenue side, we've seen this business continuing to be stable. In fact it grew the second half of last year and has not seen any decline in the first quarter. This is because it is exposed to a broader set of verticals and also has very good technologies and has been winning new designs, which we expect to be able to continue. So unlike the semi market that's actually been through quite a change in the last six to nine months, this business has been stable and continues to grow. We think this is one of the attractive elements or attributes of this more diversified set of products.

Secondly as it related to China, just to clarify, the existing AE facility in Shenzen, we will have to leave within the next two years and we expect to consolidate into an existing China plant also in Shenzen into Artesyn. So there's some very natural, we think, synergies related with that kind of move. If you look at the tariff situation, because of the customer mix and footprint of company, there's actually very low tariff exposure which Artesyn EP would face.

Yuval Wasserman: And Artesyn EP has manufacturing sites in the Philippines as well.

Yeuk-Fai Mok: That's right.

Yuval Wasserman: It's not only Chinese based. And the content that is imported from China back to the U.S. is very minimal.

Operator: Our next question first line of Pavel Molchanov from Raymond James.

Pavel S. Molchanov: I am curious why you are borrowing almost the entire purchase price given that you have $350 million of cash on the balance sheet and obviously you wouldn't spend all of that, but 50:50 kind of cash debt split would that make some sense?

Yeuk-Fai Mok: Yes, a good question, Pavel. We looked at this carefully and there's really two or three key factors. First of all, we believe we're able to acquire very attractive level of financing for this transaction, which allows us to keep a lot of financial flexibility, particularly in this time of some uncertainty with respect to the semiconductor market. In addition, it gives -- it leaves our options open to pursue other investments or other share capital allocation priorities and finally while we do have a lot of cash, a fair amount of that is offshore and not as easily accessed and as part of our financing agreement, in that agreement we get credit for all the cash we have on hand. So it effectively gives us credit for the cash we have on the balance sheet. So we felt at this time this was the prudent way to approach the transaction and it gives us the flexibility as we see this business grow and semi improve, we have significantly deleveraging power and so give us optionality going forward to bring the financing level down, sort of at the time that we choose and in the interim gives us lots of flexibility to operate the business.

Pavel S. Molchanov: Okay. Can you also talk -- you talked about the gross margin and operating margin of the acquired company. Can you talk about the tax rate that we should model I suppose for the combined asset base at this point?

Yeuk-Fai Mok: Yes, the tax rate for Artesyn EP runs in the very low 20s and I think a blended rate is appropriate for at least the near term. Over time, we think there's opportunity to actually bring the blended rate back towards our own kind of mid-teens rate. But that will take -- that certainly would be within that -- wouldn't be before that 18 to 20 month -- 24 month period.

Pavel S. Molchanov: Okay and then lastly going back to the top line of that. Obviously, there's some the cyclicality to Artesyn's business, but just conceptually. Is a GDP growth rate? GDP plus, how should we think about that?

Yeuk-Fai Mok: Yes, we do think of this as a GDP plus growth business, obviously with opportunities to improve that through share gains and some of the attributes we can bring to it, But we're modeling a GDP plus growth business. There is also some moderate seasonality in the business. It tends to be a little stronger in the second and third quarters, but it's pretty small. We don't see a lot of variation quarter-to-quarter, mostly depending on timing of projects, which can be a little bit lumpy.

Yuval Wasserman: And Pavel, if you compare this business to the semiconductor wafer fabrication, the cyclicalities, this is a fairly stable business in comparison.

Operator: And our next question comes from the line of Tom Diffely from D.A. Davidson.

Thomas Robert Diffely: One follow up question on the geography. When you look at the footprint beyond your referenced facility in China and the Philippines, are there any other meaningful geographic pieces?

Yeuk-Fai Mok: A lot of the -- the footprint of Artesyn is Asia based. That's where the manufacturing operations are. But It also sells globally and so the revenue distribution is pretty balanced around the world and they have sales, operations and distribution worldwide. A lot of the engineering and infrastructure is also Asia based as well as U.S. based.

Thomas Robert Diffely: Okay, thank you, and then, Paul, when you look at the projections you're making, what is your assumed rate on the debt in those projections?

Paul R. Oldham: Yes, our term loan is priced at LIBOR plus 75 for really any perceivable scenario. It is a range that can go up to LIBOR plus two, but that would have to be at net debt levels of greater than 1.5 and we just don't see ever being close to that, so LIBOR plus 75.

Thomas Robert Diffely: Okay. And then there's no penalty for prepayment of the debt over time?

Paul R. Oldham: No.

Yuval Wasserman: No.

Yeuk-Fai Mok: No prepayment and Tom our intent is to use our deleveraging power to accelerate payment of the debt as we integrate the businesses and the semi recovers.

Thomas Robert Diffely: Okay. And then finally, Paul, when you look at the synergies that you're projecting over the next few years, where is that coming from? Is that COGS based synergy or is it OpEx?

Paul R. Oldham: It's both, it's really both, Tom. We do think there's meaningful COGS based synergy through things, as Yuval mentioned, factory utilization, improvement and optimization, we think there's meaningful supply chain synergies in the operation and we think we can utilize a lot of the Artesyn capabilities around some vertical integration that we can improve our cost base. In addition, there's we think there are synergies obviously in the infrastructure, mostly around traditional corporate type activities outside services that don't need to be duplicated and those types of things. So it's kind of balanced between the OpEx and the COGS. One thing I will say is we do think that, that both companies are very innovation led and we don't anticipate reduction in costs and engineering. We want to preserve those investments, because we think that will drive growth.

Yuval Wasserman: We will continue to innovate and develop new products and technologies, Tom. And one more thing, we believe that long term through portfolio optimization, we will improve ASP as well.

Paul R. Oldham: That's right.

Thomas Robert Diffely: Okay, great. And finally when you look at the Artesyn embedded power group itself, has that been a stable group over time? Has it been on a roll up over other companies? How would you describe it?

Paul R. Oldham: Well, I think it's been a pretty stable group. If you look at the other elements of Artesyn, the consumer and the embedded computing, I think you have pieces that are added on that kind of becomes portfolio of three companies. But the actual embedded power company has been around for a very long time, 1968. It was actually part of Emerson previously, before being owned by Platinum and so it has a long history of very strong brand and reputation in the market. And a very nice business.

Yuval Wasserman: And I would add to that. That we also bring in on board a very capable management team, both on the business side and the technology and innovation side. The company has 700 engineers around the world, very innovative, a portfolio of more than 300 patents with centers of innovation that is very capable and we believe that will help AE in our core business as well as we start to have leveraging on our core competencies together.

Operator: We have a follow up from the line of Mehdi Hosseini from SIG

Mehdi Hosseini: Just want to dig in a little bit here. It seems like less than onetime trailing sales is very attractive valuation. And perhaps the challenge here is to resize Artesyn and is this the main challenge for you over the next year or so. In that context whether any other competitive bids for these assets, whether other parties that also were interested? Any insight you can offer us will be helpful as we try to better understand how the two companies would lead more than $5 to $6 of earning.

Paul R. Oldham: Yes, it is a good question, Mehdi. First of all, I think we feel like the more relevant metric than a comparison to revenue is the synergy adjusted EBITDA of 5x. I think this reflects both the earnings power of Artesyn EP as well as the synergies, which we think we have a line of sight to. And I'll say again, this isn't about making big cost reductions or resizing Artesyn, it is about optimizing the two companies together. I already referenced for example we have some very natural synergies where AE will need to be exiting a manufacturing site within the next two years and there's a very natural fit for that slide right into the Artesyn of existing footprint. We also think there's opportunities to optimize, as Yuval said, around the portfolio leveraging our technology to bring value added products to market and so we believe the more relevant measure is really the accelerated earnings growth that can come from the combined companies.

Yuval Wasserman: Can I make a comment? Maybe Artesyn EP is a well run operation, well run operation. We were impressed through the process of due diligence and it's a well run company. And as we said earlier, we do have opportunities to improve both gross margins and operating income margins as we go through the integration process. But the really important thing to understand behind this transaction is, we are basically converting Advanced Energy from a company that was a top tier operating income margins with minimal growth in EPS into a company that is broad-based industrial technology company highly diversified with top quartile financial performance with potential for more sustainable double-digit earnings growth.

Mehdi Hosseini: Just two quick follow ups. Were you also competing with other bidders?

Paul R. Oldham: Yes, so it's a good question. We have known Artesyn for a long time. We've had interactions with the company for quite a while. There was a process once there was a decision to sell the company and to maybe break up the pieces, but I think our relationship we built over a fairly long period of time, confined with the unique strategic fit that we bring to the table resulted in us being able to acquire the company.

Yuval Wasserman: And, Mehdi, we are buying Artesyn Embedded Power. We do not buy the whole company. Yes, so embedded computing and consumer product lines are not included in this acquisition.

Mehdi Hosseini: Sure. And then just quickly on the OpEx and OpEx synergies, I'm under the impression that their customer mix is very different than your existing customers and therefore you're going to have to maintain the existing channel and sales force that you would going to bring over to service the direct customers. And therefore, the OpEx synergies probably going to be realized by just a smaller footprint or is it something else? So the question has to do how are you going to manage the sales force and channel which is very different than your existing one and in that context where the OpEx synergies are going to come from?

Paul R. Oldham: Yes, it's a good question. First as we showed Artesyn sells to really marquee customers globally. They do that both through some direct sales, which are highly leveraged because these are large companies that combine big quantities as well as indirect channels. And as you recall, we already have a footprint in very similar markets with our industrial applied power products and so that channel is actually very complementary to the channel that we have. So we do think that we can leverage that it, also a platform between the two companies and both accelerate the growth of products that we already have in this space as well as leverage the channel between the two companies together. As I said earlier, we think there's natural savings and things like purchase of services and corporate costs where we just don't need the same level between two independent companies, even though it is a carve out and so there's some natural savings on the infrastructure side from that perspective. We also don't need for example physical footprint in all the same places around the world from a sales channel perspective. We'll have the sales teams, but we don't need 2 physical footprints. So we do see opportunities but I think very natural, they are complementary and will yield a combined company that has a better opportunity for revenue growth and earnings growth.

Operator: I'm showing no further questions at this time. I would like to turn the call back to Yuval Wasserman, President and CEO, for closing remarks.

Yuval Wasserman: Thank you, everybody for joining us in such a short notice. We are extremely excited with this strategic acquisition. It will really transform the company into a highly diversified industrial technology company and as I mentioned earlier we expect to see significant opportunities for growth and earnings, especially earnings growth. Thank you very much and I hope to see some of you later this quarter.

Operator: Ladies and gentlemen, thank you for participating today's conference. This does conclude the program. And you may all disconnect. Everyone have a great day.