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Advanced Energy Industries, Inc. (AEIS)

Q3 2024 Earnings Call

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Joe Quatrochi

Analyst, Wells Fargo Securities LLC

Steve Barger

Analyst, KeyBanc Capital Markets, Inc.

Robert Mertens

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Robert W. Mason

Analyst, Robert W. Baird & Co., Inc.

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings and welcome to the Advanced Energy's Third Quarter 2024 Earnings Call. At this time, all participants are in listen-only mode. The question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It's now my pleasure to introduce Edwin Mok, Vice President of Strategic Marketing and Investor Relations. Thank you, Mr. Mok. You may begin.

Edwin Mok

Vice President-Strategic Marketing & Investor Relations, Advanced Energy Industries, Inc.

Thank you, operator. Good afternoon, everyone. Welcome to Advanced Energy third quarter 2024 earnings conference call. With me today are Steve Kelley, our President and CEO and Paul Oldham, our Executive Vice President and CFO. You can find today's press release and presentation on our website at ir.advancedenergy.com.

Before we begin, let me remind you that today's call contains forward-looking statements that 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, October 30, 2024, and the company assumes no obligation to update them. Any targets beyond the current quarter we 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, facilities for expansion and related costs, restructuring and asset impairment charges and unrealized foreign exchange gains or losses. Please refer to our detailed reconciliation between GAAP and non-GAAP results in today's press release.

Before I pass the call to Steve, I would turn to our announcement. On Tuesday, November 19, Advanced Energy will host our 2024 Analyst Day in New York City, where we will update our growth strategies, market views, long-term financial goals and demo our products. We welcome institutional investors and financial analysts to attend in person. A live webcast of the event will also be available on our website. More information can be found in today's earnings press release.

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

Stephen Douglas Kelley

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

Thanks, Edwin. Good afternoon, everyone, and thanks for joining the call. Third quarter financial results exceeded the midpoint of our guidance, driven by higher demand in the semiconductor and data center markets. We experienced strong design win activity across all of our target markets and made solid progress on our factory consolidation plan. In semiconductor, we delivered our strongest revenue performance since the fourth quarter of 2022. In data center computing, we continued to benefit from strong investment in AI infrastructure as well as successful new products.

In the third quarter, we delivered a record number of eVoS and eVerest qualification units for next generation etch and deposition systems. We are working closely with our customers to fine tune the performance of eVoS and eVerest subsystems to meet the demand and requirements of leading edge logic and memory processors. In addition to plasma power products, we also developed power solutions for semiconductor test and burn-in systems. This quarter, we secured a significant tester win by leveraging the performance of a high density power module originally developed for data center applications. This is an example of reusing best-in-class technology across our markets to improve engineering efficiency and reduce development time. It's a key competitive advantage for advanced energy. Our factory consolidation actions are beginning to have a financial impact, as shown by our sequential improvement in gross margin. Further improvements are anticipated in the fourth quarter and beyond. As we execute our plan to reduce fixed costs, enhance productivity and improve product mix, we remain confident as markets recover that we can achieve our gross margin target of over 40%.

Now, I'll provide some color on each of our markets. Third quarter semiconductor revenue increased 5% sequentially, exceeding our projections. We benefited from incremental demand in both leading and trailing edge logic process nodes. Looking forward, we expect further sequential revenue growth in the fourth quarter. We remain on track to deliver over 250 total units of eVoS, eVerest and NavX subsystems to our customers by the end of this year. While these shipments are contributing modestly to our revenue in the near-term, we expect revenue to become more significant in the second half of 2025 as our customers move from qualification builds into production. During the quarter, we confirmed another eVoS design win for a high volume application. We also recorded multiple wins with customers who have chosen to use both the eVerest RF generator and the NavX matching network in next generation systems.

In industrial and medical, revenue decreased slightly quarter-over-quarter. Some of our direct customers, particularly in medical, are continuing to work through excess inventories. In the distribution channel, which accounts for 50% of our industrial and medical revenue. Third quarter resales were solid and nearly 20% higher than our trough resales in the first quarter. Distribution inventory levels continue to decline. Assuming current

resale levels continue, inventory turns in the channel should approach normalized levels either this quarter or next. This normalization will likely signal that our sales into the distribution channel will begin to grow again. In this dynamic market environment, we are focused on remaining nimble, reacting quickly to capture upside opportunities with readily available products. On the design win front, activity is robust. Our latest new products, which feature leading edge efficiency, flexibility and reliability, continue to be well-received, resulting in a record funnel of new opportunities.

Within industrial, we secured many design wins, including key slots in process automation, robotics and industrial lighting. In medical, we won designs in diagnostic and therapeutic applications. Since launching our new website a year ago, we have seen an expansion of our customer base as well as a higher design win conversion rate. We believe that our optimized sales and channel strategy is positioning AE for a stronger rebound as the market recovers.

In data center computing, revenue grew 11%, sequentially, driven by increased demand from hyperscale customers, mainly for AI applications. With continued strong investment in AI and an improving supply of GPUs, we expect strong revenue performance in the coming quarters. At the OCP Global Summit earlier this month, we announced multiple new products, which address the substantially higher power requirements of AI applications. Several of these new products will begin ramping to production in the next two quarters. The accelerating power consumption and cost of AI data centers mean that AE's industry leading power efficiency, power density and system reliability are highly valued by our customers. We believe that our engineering expertise and manufacturing capabilities will continue to give us a competitive edge in this market.

In the telecom and networking market, revenue decreased quarter-over-quarter due to lower demand. While we expect the third quarter to be a trough for the year, market conditions will likely remain soft over the next few quarters.

Now let me share a few closing thoughts. We are executing well in a dynamic market environment and are delivering upside to our expectation for the year. Semiconductor revenue is trending ahead of our prior outlook of a flat year. We now project 2024 revenue to grow at a single digit percentage over 2023. In data center, we expect strong revenue again in the fourth quarter and double-digit growth for the year. In industrial medical, we expect revenue to bounce around current levels for the next quarter or two as distributors and end customers continue to work down inventories. There is potential for upside coming from recent design wins.

Looking beyond 2024, we are excited about our prospects for profitable revenue growth with strong customer pull for our new products and technologies and recent design wins beginning to ramp to production. We are well-positioned to gain meaningful share as markets recover. Our efforts to structurally lower fixed costs are beginning to yield results and are a key part of our plan to move gross margins above the 40% threshold. Finally, we continue to actively pursue our acquisition strategy and have a solid pipeline of potential opportunities. Paul will now provide more detailed financial information.

Paul R. Oldham

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

Thank you, Steve, and good afternoon, everyone. Third quarter revenue was \$374 million, slightly ahead of the midpoint of our guidance with guidance. With higher gross margin performance, we achieved earnings per share of \$0.98 beating our guidance of \$0.90. Semiconductor revenue was above our expectations as we captured incremental demand in a dynamic environment. Data center computing grew again on strong AI related demand, while inventory destocking continued to limit industrial and medical revenue. We are executing our plan to reduce costs and operations by consolidating manufacturing into larger sites and are beginning to see the results of this

effort. Third quarter gross margin increased 100 basis points quarter-over-quarter, and we expect a sequential increase again in the fourth quarter. In addition, as we previously announced, we recorded a restructuring charge primarily related to the planned closure of our last production site in China by the middle of next year.

Now, let me go over our financial results in more detail. Total revenue of \$374 million increased 3% sequentially, but decreased 9% year-over-year. Semiconductor revenue was \$197 million, up 5% sequentially and 7% year-over-year. Our team acted swiftly to capture higher demand and deliver upside to our expectations. Service revenue also increased from the prior quarter. Industrial and medical revenue was \$77 million, down 3% sequentially and 33% year-over-year. We believe this market is close to bottoming after several quarters of customer inventory destocking. We're encouraged that inventory in the channel continues to decline and that our distributor resale data suggests that end demand remain solid.

Data center computing revenue is \$81 million, up 11% sequentially and 18% year-over-year, driven by continued strength in hyperscale demand for AI applications. Telecom and networking revenue was \$19 million, down 22% sequentially due to lower demand and timing of a meaningful networking customer program that moved into Q4. Q3 gross margin was 36.3%, up 100 basis points sequentially and slightly ahead of our guidance. The improved gross margin was largely the result of initial manufacturing cost improvements as we transition products between factories. Operating expenses of \$97 million, increased \$1.8 million sequentially on higher spending related to customer qualification of our new platforms and the timing of some employee benefit expenses. Operating income for the quarter was \$39 million. Depreciation was \$11 million and our adjusted EBITDA was \$50 million. Other income of \$4 million was flat from Q2.

Our non-GAAP tax rate was 14.5% below our expectations of 16% to 17% due to mix of earnings and favorable discrete items. As a result, third quarter non-GAAP EPS was \$0.98 per share, compared to \$0.85 per share in the prior quarter and a \$1.28 per share a year ago. During Q3, we also recognized \$28.5 million in restructuring expenses, primarily for employment related charges tied to the closure of our last China production site. We expect to incur an additional \$3 million to \$5 million in restructuring costs in Q4 as we finalize manufacturing and other consolidation actions. We expect these actions will help us improve margin leverage and profitability as revenue recovers. As a result, GAAP loss per share, including restructuring and other non-cash non-recurring expenses, was \$0.38.

Turning now to the balance sheet. Total cash and cash equivalents at the end of the third quarter was \$657 million. Net cash of \$93 million was up \$14 million from Q2. Gross cash decreased sequentially as we prepaid \$345 million of our term loan. Concurrently, we amended our credit facility to increase our revolver capacity from \$200 million to \$600 million. These actions reduced net interest expense while preserving the terms of the existing credit agreement and increasing our overall financing capacity and flexibility to fund growth, repurchase shares and meet other corporate needs. Cash flow from operations was \$35 million. Inventory decreased \$5 million sequentially, while turns remained flat at 2.5 times. DSO decreased 3 days to 62 days, and receivables decreased by \$3 million on higher revenue. DPO decreased from 60 days to 50 days, primarily on timing of payments for inventory. During the third quarter, we invested \$12.6 million in CapEx or approximately 3% of sales. We paid \$3.9 million in dividends and repurchased \$1.8 million of stock at an average price of \$93.58.

Turning now to our guidance for the fourth quarter, we expect revenue to increase from Q3 on pockets of strength, particularly in semiconductor. We expect semiconductor revenue to increase sequentially from Q3 and to grow low to mid-single digits for 2024, up from our previous expectations of flat year-over-year. In industrial medical, we expect quarterly revenue to be flat to up on new design wins. Data center computing revenue should remain at a high level in the fourth quarter, driven by strength at both hyperscaler and enterprise customers. We expect telecom and networking revenue to recover from the Q3 trough to the low \$20 million range. As a result,

we expect fourth quarter revenues to be approximately \$392 million, plus or minus 20 million. We expect gross margins in the fourth quarter to improve to about 37% as we continue to execute our manufacturing cost improvement plans. We expect operating expenses to increase to \$98 million to \$100 million on accelerated investment in new product qualifications and modestly higher variable costs. We believe these investments will accelerate adoption of our next generation technologies and enable us to grow share as the markets recover.

Other income should be in the range of \$1.5 million to \$2 million due to lower cash on the balance sheet, partially offset by lower interest expense. We expect the Q4 tax rate to be around 15%. As a reminder, we expect the full adoption of the global minimum tax regime in 2025 to increase our tax rate to approximately 18% to 19%. As a result, we expect Q4 non-GAAP earnings per share to be a \$1.08 plus or minus \$0.25.

Now for some concluding comments. Looking forward to 2025, we expect revenue to grow as markets recover over the course of the year and design wins begin to ramp. In semiconductor, we expect our next generation platforms to start initial production in second half of 2025 with a more meaningful ramp in 2026. Industrial and medical, we believe that our new product and design win pipeline, expanded digital platform and sales outreach will drive share gains as inventories normalize and the market recovers. Data center demand for our proprietary solutions should remain strong on continued investments in AI infrastructure. We're making progress and improving gross margins and believe we are on track to deliver over 400 basis points of improvement driven by structurally lower manufacturing materials costs, completion of transition actions, higher volumes as markets recover and improved product mix. Finally, our optimized balance sheet will continue to provide capacity and flexibility to pursue strategic acquisitions.

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. Thank you, our first question is coming from the line of Brian Chin with Stifel. Please proceed with your question.

Brian Chin

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Hi, there. Good afternoon. Thanks for letting us ask a few questions and congratulations on the results. Maybe first question, can you just give maybe a rough idea of what drove the upside on the semi equipment revenue in Q3 and then maybe a little bit in the Q4 outlook? And also just broadly, some rough idea of how much of your semi equipment revenue is typically leading versus trailing edge?

Stephen Douglas Kelley

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

A

Sure, Brian. As a reminder, in Q2, we saw growth in Q1, Q3 showed growth over Q2 and we're anticipating further growth in semi revenues in Q4. So, the trend has been good. And what we've seen this year is that most of the growth has been driven by logic nodes and we've seen it from both leading edge logic as well as trailing edge. We don't have an exact breakdown between leading edge and trailing edge because our equipment can be used in both applications. So I can't really help you there.

Brian Chin*Analyst, Stifel, Nicolaus & Co., Inc.*

Q

Okay. That's fair enough. And I'm not going to hold you to a prediction on WFE spending in 2025, but there have been some other customers of yours and other OEMs have commented on that. And so, let's say it's, mid-single digit growth next year, kind of similar-ish maybe to this year. And when you think also about the moving pieces where there's some concerns about trailing edge, particularly China spending growing next year, I think people think it declines, maybe leading edge is up. When you think about put all that together, what's your sense in terms of like quarterly trends on the semi equipment business, do you think you can kind of move sideways here in the first half next year or how would you sort of calibrate that for us?

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

A

Yeah, I think, first of all, we see growth in 2025 over 2024, but we think it's more weighted towards the second half and that's based both on customer inputs and also on the anticipated ramp of our eVerest and eVoS design wins. So, we think 2025 will continue to improve, but first half will be less than second half. And if you look at this year in 2024, our second half is roughly 10% better than our first performance on revenue, so it's consistent.

Brian Chin*Analyst, Stifel, Nicolaus & Co., Inc.*

Q

Okay. So that – does that suggest that, just to be clear, first half of next year could be similar to second half of this year.

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

A

It's hard to say, but I think the first half was definitely weaker than the second half next year for sure.

Brian Chin*Analyst, Stifel, Nicolaus & Co., Inc.*

Q

Okay. Got it. Maybe one last question. Based on your understanding of how much of your data center pickup is being driven by high end AI infrastructure, we're getting obviously, there would be a more pressing need for higher power density and efficiency. Do you think that could be a catalyst maybe to extend the runway for data center growth over a longer period than maybe you previously described?

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

A

Yeah, I think it's an interesting phenomena. Obviously, what we see is that the refresh cycles are accelerating essentially. So we're working with our customers very closely on Generation N plus 1 and N plus 2 right now. And so we're I think in not too distant past, there'd be two years between refresh cycles is moving closer to a year now and that's tracking closely with the introduction of new GPU technology. And so, with each new generation of GPUs, the power requirements tend to go up. And so, part of our value proposition for our customers is our ability to be nimble and to develop these solutions relatively quickly. And so, what we've always sold on is, is power density, efficiency and reliability and those become even more important factors for these AI data centers because they're expensive and they're power hungry. So, if we could squeeze out more efficiency, it saves everybody money. And the power density comes into play because we're trying to basically deliver more power in the same size box. And our engineering team is very capable when it comes to power density, efficiency and reliability.

Brian Chin*Analyst, Stifel, Nicolaus & Co., Inc.*

Great. Thank you. I appreciate it.

Operator: Our next questions are from the line of Joe Quatrochi with Wells Fargo. Please proceed with your questions.

Joe Quatrochi*Analyst, Wells Fargo Securities LLC*

Yeah. Thanks for taking the questions. Maybe one on the industrial and medical side. Curious as to just kind of if you could kind of talk a little bit more about what you're seeing from a just inventory destocking and your confidence level that that kind of starts to play out in return for better growth algorithm as we look into next year.

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

Yeah, I'd be happy to, Joe. So, just, looking back, we started this inventory correction back in Q4 of 2023. So, believe it or not, it's been a year. We're still not quite through it. Roughly half our business and industrial medical goes through distribution. So, the distribution metrics are an important barometer of market health. And so, what we've seen this year is that after resales dipped in Q1, we saw a return to relatively strong resales in Q2 and Q3 and then we're expecting relatively strong resales in Q4. At the same time, we've seen distribution inventory continue to decline. And so, we believe looking at the trend lines that at some point late Q4, sometime in Q1, we should be in a position where inventory in distribution is normalized. And our thesis is that once we see normalized inventory levels, we should see a return to growth from distributors as far as what they order from us. So, that's our view. If we look more broadly, it's a little more difficult sometimes to gauge how much inventory the end customers are holding. And so, it's a mixed market. Some customers are working through excess inventory from the supply chain crisis, and some have already worked their way through it. And so that's – part of the beauty of the industrial medical market, is it's very broad. There's thousands of customers. And our objective is to continue to broaden our customer base. And that's going to lead to a steadier business over time.

Joe Quatrochi*Analyst, Wells Fargo Securities LLC*

Thanks. And maybe as a follow-up, just as we think about like the puts and takes of gross margin guide for the fourth quarter. Can you talk about just the mix dynamic there, I mean, I think, semi is maybe a little bit better than what we're thinking and industrial flat to up and then data center, it sounds like maybe flat. So can you just kind of parse out like help us understand why 37% is still kind of the right way to think about gross margin, not, maybe a little bit higher than that.

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

Yeah. This is Paul. I'll make a couple of comments. First, we think that 37% is kind of right on track to our model, considering we still have a lot of transition activity going on in manufacturing. So I think that's – we continue to expect things to be up a little bit. We did see a little headwind to mix this quarter. Interestingly enough, at the product level. So, we could get a little bit of a little bit of benefit there, but I think we feel comfortable with the 37%, where it's at. And again, remember, we do have, some of these transition costs, as we are now getting into full swing of the China factory closure and transition.

Joe Quatrochi*Analyst, Wells Fargo Securities LLC*

Thank you.

Q

Operator: Our next question is from the line of Steve Barger with KeyBanc Capital Markets. Please proceed with your question.

Steve Barger*Analyst, KeyBanc Capital Markets, Inc.*

Yeah. Thanks. Steve, great to hear about this continued momentum in design wins. I think you said there is a record funnel of new opportunities. Can you quantify that all in terms of how that funnel looks compared to a year ago in terms of number of projects or dollars or however you're kind of tracking that?

Q

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

Yeah, Steve, we haven't given exact numbers on the funnel, but one thing we do track pretty closely is conversion rates. So we have an opportunity funnel and then we track, what percentage actually turn into design wins. And I can tell you, we're tracking above one in three. So that means one out of every three opportunities converts to a design win, which we verify with either a purchase order or some other written commitment from the customer. So I think that's pretty good. And the key for us is basically expanding the funnel both through our website, where we've seen a lot of good uptake from new customers and also through our distributor network and with our direct salesforce. So, in distribution, it's interesting, we're basically the top four power supply vendor for each of our three biggest distributors. We gained share over the last two years at each of those big distributors. And so the momentum is building in distribution as well as with our website as well as with our direct salesforce.

A

Steve Barger*Analyst, KeyBanc Capital Markets, Inc.*

Yeah, that's really great to hear. And presumably you're still relatively low share in those newer markets that you're serving...

Q

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

Yeah, we're still single-digit market share in these new markets, so there's plenty of upside for us.

A

Steve Barger*Analyst, KeyBanc Capital Markets, Inc.*

And if I look at the guidance, if a couple of things swing your way in for Q2, you'll be back to that \$400 million in quarterly revenue. If that happens, would you think that's a baseline you'll build on as you go through next year or are there any seasonal things that would cause 1Q to be lower?

Q

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

Yeah, it's a good question. And obviously we're not guiding out to 2025 at this point, but we do see some seasonality in our – in some parts of our business. The industrial and medical piece, does have some seasonality as people cross fiscal year ends. So, we'll see how people gauge their inventory coming into Q1. Also, certainly

A

last year, we saw some seasonality in our semi business, which declined from Q4 to Q1 and we largely attributed that to customers kind of stocking, finishing their stocking activities in Q4 and taking a little bit of a breather in Q1. So, we could certainly see some seasonal effects. And I guess we're not at this point projecting a big market turnaround or the bigger factors, that tend to overcome the seasonal effects, at least not in the near term in our markets.

Steve Barger

Analyst, KeyBanc Capital Markets, Inc.

Understood. Thanks.

Q

Operator: Our next questions are from the line of Krish Sankar with TD Cowen. Please proceed with your questions.

Robert Mertens

Analyst, TD Securities (USA) LLC

Hi, this is Robert Mertens on the line on behalf of Krish. Thanks for taking my questions and congrats on the strong quarter. It seems like the growth in data center market was above your prior expectations for the – come in for the quarter and remain strong through the end of the year. What sort of visibility do you typically have for the products going into this business and sort of the sustainability of demand heading into next year?

Q

Stephen Douglas Kelley

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

Yeah, it's interesting. We're getting more visibility because of the compression of the design cycles. And so, we've won some major new designs just this past quarter that will start ramping as soon as December. So, things are happening more quickly, which is good news. And it seems like this cycle could last longer than the normal. I think we've noted in past calls that typically the data center market goes through inflection point, five or six quarters of strong consumption, followed by a few quarters of digestion. And we've seen that pattern in the past. It could be different this time. I think the influence of AI, the influence of these new generations of GPUs could very well extend the cycle.

A

Robert Mertens

Analyst, TD Securities (USA) LLC

Got it. Thank you. And then, just another question on the gross margin side. Obviously, you guys been doing a lot of work on the manufacturing efficiencies and it will grow with volumes as well. Did I hear correctly you mentioned you're on track to grow 400 basis points, is that in regard to next year?

Q

Paul R. Oldham

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

Yeah, it's a good question. I think if you step back and look at our overall long-term gross margin targets, they remain unchanged. And if you go back to Q1, we were around 35% and we said we thought we could get to a 40% or better at \$450 million, roughly in revenue. So, when you look at the pieces of that, a little bit of that is material premiums needed to finish abating. We thought mix could play a little factor. The biggest things came from improving our manufacturing cost. We said that was 200 plus basis points and then of course, getting the volume up. If you look at this point where we are now three quarters into the year, I think the material premiums have largely abated. There's always a little bit of noise, but I think that's kind of not a factor at this point. And we're a little ahead from a manufacturing cost perspective.

A

So we're encouraged that we've kind of reached that tipping point where we're seeing more benefits of lower costs kind of tipping over and outweighing the transition costs, and that should continue on that track. And remember, we talked about closing our China manufacturing site. That's a pretty significant action that will have its largest effect kind of at the end of Q2 of the coming of the coming year. So, we feel very good about that 200 plus basis points. As I mentioned earlier, mix was a little negative this quarter. We probably get a little bit of that back and then volume has yet to kick in.

So, when we look at those elements, being a little over 36% this quarter projects and 37% next quarter, we think we're on track to get to that 40% or better. And remember, as our new products get into the market and start to ramp, we think there's another 200 basis points to 250 basis points from what I'll call structural mix, better margins from new products, higher percent of sole sourced revenue. And that should come in over a course of a product cycle, so call it 12 to 24 months. That should put us firmly above the 40% and give us room to stay above 40% even in a down market.

So, we're encouraged that we're now finally starting to see maybe some of the fruits of our efforts. We think we're on that track. This is, I guess, our third quarter of sequential improvement with Q1 being the bottom of gross margins. And when we look forward, we think we'll continue to stay on that path to get back to 40% as our markets recover.

Robert Mertens

Analyst, TD Securities (USA) LLC

Q

Great. Thank you. I appreciate it.

Operator: Our next question is from the line of Rob Mason with Baird. Please proceed with your question.

Robert W. Mason

Analyst, Robert W. Baird & Co., Inc.

Q

Yes, good afternoon. There was a – Steve, you made the comments around the design wins on the semiconductor side, new products as you get into the second half of next year and into maybe further more so into 2026. I'm just curious, as you think about what your ramp looks like today, how much of that is from design wins that you've, I guess, banked today versus maybe what is in the pipeline from a risk adjusted likelihood to win standpoint. Just kind of the visibility around that.

Stephen Douglas Kelley

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

A

Yeah. So, let me just back up a little bit. We introduced eVoS and eVerest a little more than a year ago. Then we came up with this NavX matching network this summer. And so, between those three new platforms, we'll ship over 250 units by the end of this year, which is unprecedented from a volume standpoint. Those are going to every customer that we have. So, literally every plasma power customer we've ever sold to is sampling at least one of these technologies, if not two or three.

And so, what we've seen is a sense of urgency from our customer base. They need this technology to get to the next level in both logic processes and memory processes. They're tackling some really thorny technical issues, and our technology is helping them get over the hump, essentially. So, that's what's driving the sense of urgency. And some of that's reflected in our increased R&D spending, you've seen in Q3, you'll see it again in Q4. We're

basically accelerating the builds of these systems and so that that R&D spending is going towards more units and not necessarily more people. And that's pretty good news for the company actually.

Robert W. Mason

Analyst, Robert W. Baird & Co., Inc.

Q

That's helpful. Just as a follow-up, how are you thinking about this maybe for Paul, but how are you thinking about free cash flow in the fourth quarter and how you finish up the year?

Paul R. Oldham

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

A

Yeah, free cash flow, I think will be up from Q3 and Q4. We usually don't guide to that. But if you look at the factors, obviously, income's going to be higher, I think we'll have a better balance of working capital. When we look at our inventory and accounts payable trends, I think those are looking positive relative to the first part of the year. And if you remember the first part of the year, we had a couple of items that impacted free cash flow in terms of timing of tax payments or any alternative that we don't have in the fourth quarter.

So, I think the fourth quarter will prove to be a better quarter than Q3, for both operating cash flow and free cash flow. I guess the other aspect is, if you look at CapEx, CapEx in total was down a little bit in the third quarter and as a percentage of sales was coming back a little bit. And that's going to bounce around still the higher end of our range, 3% to 4% because we are making those investments in our factories. We are actually making a fair amount of CapEx investments in what I'll call R&D, which supports NPI for tooling test fixtures and that type of activity. And we've been working on some things that help the company's IT infrastructure and capability.

So, those investments will continue for the next year or so. We'll continue to see a little bit of elevated CapEx. But again, that's not a large number in the grand scheme of things. It's sort of that 3% to 4% of sales. So, should be better in Q4. And in general, we should track our historic levels of free cash flow conversion that we've seen in the past.

Robert W. Mason

Analyst, Robert W. Baird & Co., Inc.

Q

Thank you.

Operator: Our next question is from the line of Jim Ricchiuti with Needham and Company. Please proceed with your question.

Jim Ricchiuti

Analyst, Needham & Co. LLC

Q

Thank you. Hey, Paul, just follow-up on the gross margin commentary.

Paul R. Oldham

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

A

Yes.

Jim Ricchiuti

Analyst, Needham & Co. LLC

Q

So, how do we think about the – can you quantify the headwind from the transition of China manufacturing, yeah and does that remain at similar headwinds Q4 and gradually abates as we get into the first half of the year 2025?

Paul R. Oldham

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

A

Yeah, we haven't broken that down precisely, Jim. But if you look at what we said in the past, if you recall back in the early part of the year, we thought that getting around \$400 million would get us up 250 basis points to 300 basis points and then as we saw the Street sort of modulate around getting to around 37% by the end of the year, we felt that, that generally reflected these additional headwinds that we expected. So, I guess you could infer from that that, that's anywhere from 50 basis points to 100 basis points. I think those do gradually get better. They don't get better all at once, but I think over the next three quarters you'll see those abate and that'll contribute to getting the whole amount of our manufacturing cost improvements to fall through.

Jim Ricchiuti

Analyst, Needham & Co. LLC

Q

Got it. And Steve, maybe just a question for you, just on the design win activity, sounds like you're seeing some nice wins. You alluded to one eVoS design win, high volume application. I wonder if you could elaborate on that. And then, just a follow-up on the I&M design wins in the robotics and the process automation. Are these existing customers for the most part or are you winning some business with new customers? Thanks.

Stephen Douglas Kelley

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

A

Oh, sure. Yeah, yeah. So, Jim, I can't go into much more detail on the eVoS win because of confidentiality provisions with our customers, but I can confirm it's high volume and it will go to production next year. So, I think there are a lot more of those wins in the pipeline and we'll be able to announce more in the coming quarters. But we're very encouraged with the degree of interest and the fact that we have units not just in our customer labs, but also in their end customer fabs. And so, this process is well underway right now, getting these design wins confirmed.

On the industrial and medical side, it's interesting, we have design wins in a number of new areas. Every quarter seems like a new adventure for us, probably due to our website. So, the website's brought in a lot of new customers. So, just in Q3, we saw new customers in the mil-aerospace, factory automation test and measurement. We had new wins in automation, major wins, thin films, stage lighting, test and measurement. I can go on and on. But we're seeing customers that have high end requirements where they have a, say a factory production line, which needs to have high reliability and high power efficiency. They'll come to us because that's the type of product that we manufacture and design.

And so, there's a lot of momentum, I think, in the industrial medical space. And we're funding it through our website, through our sales force and through our distribution network. So, we have a lot of activity going on, and we're very optimistic about growing faster than market in the coming years in industrial and medical.

Jim Ricchiuti

Analyst, Needham & Co. LLC

Q

Okay. Thank you.

Stephen Douglas Kelley

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

A

Thanks, Jim.

Operator: Our next question is from the line of Scott Graham with Seaport Research. Please proceed with your question.

Scott Graham

Analyst, Seaport Global Securities LLC

Q

Hey, good afternoon. Well done. Thanks for taking my question. I was wondering if there's a way to parse out what is the destocking impact versus, just sort of I know you're saying that resales, which I assume you mean POS is better. 33% down is a big number in I&M and I was just wondering is that essentially all destocking if you're saying that resales are improving?

Paul R. Oldham

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

A

Yeah, I think it's – there's a couple of things. First, I think 33% down and I think it was a similar number last quarter, maybe even more, is pretty unprecedented in industrial and medical. And so, if you step back from that, I think our view is what's driving that level of volatility is essentially the recovery from the parts and supply crisis that we went through. For a long time, people couldn't get parts. Industrial and medical was the last group that could get them and that drove record numbers of revenue in 2023.

So, first, I think the compare is comparing probably to a to a higher number than is the normal market. I think the flip side is also true. Now that we are into 2024, people are digesting all the things that they got. And so, you see a pretty tough comparison year-over-year.

If you look at what we believe is end market demand, what our customers would actually be drawing, we think that's been relatively stable. There's been some ups and downs, but it's much more stable. And we hear that from our distributors. We kind of hear it from customers. So, at least in this market, we're not seeing a big falloff in the end market. It's – again, some ups and downs. And when we look at the sell through, the point of sale, we talked in our call is relatively solid. And if you look back over the last eight quarters, you can see that, that number has not modulated nearly as much as, as what we've seen. And what I'd say when you look across the industry at what our distributors and our peers have seen, that suggests this is mostly an inventory phenomenon. It's mostly a stocking issue where people took parts over the course of the year when they got a year without being able to get what they wanted. And they've spent the last year kind of digesting that. We think we're getting towards the end of that. Obviously, this isn't a perfect science, but we do see some encouraging signs. The point of sale has stayed relatively solid. The backlogs come down again. When we do some math, as Steve said, it looks like the inventory levels could be getting back to a normalized level either at the end of Q4 or Q1.

That suggests that the artificially depressed level we're seeing now as people destock, could be coming to the end in the next quarter or so. That means we should see some recovery in our business, at least up to a normalized level. What's a normalized level? It's hard to tell, but it's just probably somewhere in between the record and the trough. And so, you can just look at the math around that and say that, that could still be a meaningful pickup for us sometime next year as those inventories normalize. And that's kind of how we're thinking about it. And clearly, in the meantime, we're doing everything we can to get more eyes on our products, expand our channel, get in front of more customers, get design wins. And we think that will give us some tailwinds as people start to spend money again and the new products start to ramp.

Scott Graham*Analyst, Seaport Global Securities LLC*

That's very helpful. Thank you.

Q

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

You bet.

A

Scott Graham*Analyst, Seaport Global Securities LLC*

I have another question on DC, data center sales, and I know you have commentary here that says that strong sales in the coming quarters. Is that sort of like fourth quarter and first half of next year comment or do you actually have visibility based on conversations with your customers that maybe it's more like a year's worth of visibility?

Q

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

Yeah, I think that's a tough question to answer. As Steve said, we have more visibility than we usually do because there's a bit of a herd mentality in this market and you have these periods of digestion. But I would say based on our commentary and then the products that we've seen designed in and could ramp, I think we certainly feel good about the next few quarters. Could I go out a year and say it's still going to be strong? I mean, in tech world, a year is forever. So, it could be different in this cycle. There's a lot of investment going into it, but I think it's hard to predict out a year at this point. But certainly in the near to mid-term, it seems like there's a lot of demand for what we're doing and we see it both in terms of orders and design wins and product interest on new technology.

A

Scott Graham*Analyst, Seaport Global Securities LLC*

Got it. Thank you.

Q

Operator: Thank you. At this time, we've come to the end of our question-and-answer session. I hand the floor back to Edwin Mok for closing remarks.

Edwin Mok*Vice President-Strategic Marketing & Investor Relations, Advanced Energy Industries, Inc.*

Thank you, Rob, and thanks, everyone, for joining today's call. We look forward to seeing many of you at our 2024 Analyst Day on November 19. Goodbye.

Operator: Thank you. This does conclude today's teleconference. We thank you for your participation. You may now disconnect your lines at this time.

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