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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Advanced Energy Industries Q4 2019 Earnings Conference Call. (Operator Instructions)

I would now like to induce your host for this conference call, Mr. Edwin Mok, Vice President of Strategic Marketing and Investor Relations. You may begin.

Yeuk-Fai Mok - *Advanced Energy Industries, Inc. - VP of Strategic Marketing & IR*

Thank you, operator. Good morning, everyone. Welcome to Advanced Energy's Fourth Quarter 2019 Earnings Conference Call. With me today are Yuval Wasserman, our President and CEO; Paul Oldham, our Executive Vice President and CFO; and Brian Smith, our Director of Investor Relations.

If you have not seen our earnings 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 today. Before I begin, I'd like to mention that Advanced Energy will be participating at multiple investor conferences in the coming months. As other events occur, we will make additional announcements.

Let me remind you that today's call contains forward-looking statements, which 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 and uncertainties is found on our filings with the SEC. All forward-looking statements are based on management's estimates, projections and assumptions as of today, February 18, 2020, and the company assumes no obligation to update them.

Long-term targets, including integration targets and aspirational goals presented today, should not be interpreted in any respect as guidance. Today's call also includes non-GAAP financial measures. An explanation of these measures as well as reconciliations between GAAP and non-GAAP measures are contained in our press release and slide presentation.

During today's presentation, in addition to our reported financial results, we will provide revenue comparisons on a pro forma basis, which includes full historical revenues of the Artesyn acquisition in prior periods. In addition, we'll provide revenue comparison on an organic basis, which excludes the contribution of Artesyn revenue. We believe these data will help investors better understanding the performance of our results. Details of Artesyn historical revenues by market can be found on our website.

With that, let me pass the call to our President and CEO, Yuval Wasserman. Yuval?

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

Thank you, Edwin. Good morning, everyone, and thank you for joining us on this call. Before I start, let me touch on the outbreak of coronavirus. We are taking this threat seriously and have assigned an executive lead to global team to mitigate risks and manage any impact on our employee base and operations. Since our most important priority is the health and safety of our employees, we are taking a prudent approach in restarting our Chinese production facilities in full coordination and compliance with local government.

We have opened all our factories. However, with the uncertainty due to disruption in transportation, government-imposed limitation of people density in commercial buildings and a slow rate of restarting supply chains after the extended break, our assumption is that our production outlook would be affected. And for that reason, our Q1 revenue guidance will be set below our growing customer demand. As the situation continues to evolve, we are actively collaborating with our suppliers and customers to mitigate the impact on shipments.

Now let me turn to our business. The fourth quarter marked a strong finish to a transformational year for Advanced Energy. Our quarterly revenue and earnings surpassed the top end of our guidance ranges, driven by market recovery in the semiconductor and Data Center Computing verticals and incremental revenue growth from multiple prior design wins. On a pro forma basis, including a full quarter of Artesyn revenue in prior period, our Q4 total sales grew over 17% sequentially. Our team executed well to meet the increased demand, while at the same time, continuing to focus on expanding our design win pipeline with new products and technologies to support future growth.

This quarter, we also started shipping products from our new factory in Malaysia, following initial customer qualification consistent with our strategy and in line with our customers' current and future manufacturing plans. For the full year 2019, despite sluggish market conditions for most of the year, our revenue increased nearly 10% to a record level of $789 million as we generated incremental revenues from our acquisition of Artesyn Embedded Power. Artesyn was solidly accretive to our Q4 results, and the integration is going extremely well.

Going into Q1, demand for our products remain strong and growing. However, as mentioned earlier, we expect our near-term revenue outlook to be impacted by the evolving situation in China related to coronavirus outbreak. My forward-looking comments will focus on the demand trends we see across our markets, while Paul will provide you with more details around the impact of the coronavirus on our operating outlook.

Turning now to our markets and performance in the fourth quarter. Our sales into the Semiconductor Equipment market grew by 30% sequentially, more than double the anticipated growth rate. Market conditions continue to improve during the quarter, with strength in foundry/logic and an increase in memory demand, coupled with an end to the inventory drawdown at key customers. More importantly, design wins we secured previously started to contribute to revenue growth and further strengthened our position at our customers.

Our semiconductor service business was about flat sequentially with improved demand in Asia, offset by continued softness in North America. Based on our strong bookings and pull rate quarter-to-date, we expect overall demand in Q1 from the Semiconductor Equipment market to grow in the mid-teens sequentially.

At our December Analyst Day event, we outlined our growth strategies across the company, including details for our semiconductor market. I'm pleased to report solid progress on these growth initiatives. During the quarter, we won a design into multi-wafer chamber deposition tool with AE's unique integrated RF architecture based on the technical and cost advantages of our solutions. Also, AE penetrated additional customers with our remote plasma source due to our product's high ion density, superior chamber life and low cost of ownership.

In addition, we shipped multiple units of eVoS, our beyond RF Power solution, to 3 strategic customers for evaluation. Customers are recognizing the benefits of our pioneering tunable ion energy technology that essentially allows process engineers to tailor the ion energy profile to each specific application. Lastly, we saw good traction with our broad portfolio of semiconductor power solutions, which will continue to drive increased dollar content within our customers' products.

Overall, our strategic decision to accelerate R&D investment over the last several quarters is beginning to pay dividends. Our customers are aggressively developing next-generation process solutions, and our products are being adopted into new platforms. As our design win pipeline continues to strengthen, we are confident that our sales into semiconductor applications will continue to outgrow the market.

Turning to our Industrial & Medical markets. On a pro forma basis, sales were about flat sequentially. Macro market conditions remain challenging, especially in Europe and China, as we experienced weak demand from industrial production and auto industries. Demand from solar customers were particularly light in the quarter, as we did not see any significant project investment, especially in China. This was offset by near-term improvement in flat panel display, driven by mobile OLED applications and the continued strength in the medical equipment market across multiple applications, such as diagnostic systems, surgical tools, medical lasers and cosmetic lasers.

In addition, our industrial embedded power products saw strength across multiple applications, such as motion control, robotics, horticulture, 3D printing and food processing. At the same time, we were successful in converting numerous power design wins into revenue. In medical equipment and analytical instrument market, we won multiple design wins, including an important one for a DNA-sequencing application.

We are gaining momentum in the medical space, with our 2019 sales to one of our key medical device customers grew over 30%. And in Q4, revenue from another leading customer reached its highest level in the last 2 years. And in the industrial space, for advanced power products, we secured new design wins for next-generation glass manufacturing, industrial coating and flat panel displays.

Looking forward, we expect demand from Industrial & Medical vertical to be down sequentially as several large programs were completed in Q4 and from continued overall market weakness. However, long term, we expect solid growth in this market given our design wins and improved market conditions over time.

Demand in the Data Center Computing market was substantially stronger than we anticipated. Our Q4 sales into this market grew 70% sequentially on a pro forma basis, driven by faster-than-expected ramp of multiple design wins at hyperscale customers and improvement in the overall Data Center Computing market after a weak first half in 2019. This quarter, revenue for hyperscale exceeded our expectations as we gained significant share at a Tier 1 hyperscale customer with our customized several power shelf solution.

In addition, we gained market share at a key enterprise computing and storage customer due to our high quality and ability to meet their requirements. Looking forward, although revenues may be lumpy given the large size of hyperscale projects, the successful ramp of existing design wins and our pipeline of new opportunities position us to grow in this vertical in 2020. With our industry-leading efficiency and power density, deep engineering capabilities and strong application knowledge, we are gaining share in this market.

Turning lastly to Telecom & Networking. As we projected during our last quarter's earnings call, we saw sluggish market for Telecom & Networking equipment in Q4. Currently, demand from both telecom infrastructure and networking equipment OEM is weak due to the general slowdown in IT infrastructure investments. Many telecom providers are leveraging their investment in LTE-Advanced for the initial 5G deployment, which is pushing out their next-generation 5G infrastructure spending. That said, we're actively engaged on multiple 5G base station designs.

In addition, recent design wins for next-generation enterprise and data center networking application have started to drive sales, partially offsetting the weakness in the market. Overall, we are projecting continued near-term pressure in the Telecom & Networking vertical and expect demand to approach a trough within the next 1 to 2 quarters. Long term, we believe that drivers such as 5G and enterprise refresh would support growth in this vertical.

Let me now give you an update on our progress with our Artesyn acquisition. In the first few months since the close, we have already made significant progress. Leveraging strength across the combined company, we are building an integrated company with our functional organization for efficiency, speed and accelerated innovation. Recently, we combined our sales force into a single team, which will drive key account and channel synergies, global reach and efficiency. We've also integrated our manufacturing operation under a single new leadership team, which will enable us to drive factory consolidation and efficiency across the company and supply chain leverage. While the full impact will take several quarters, we are already seeing tangible benefits from combined supply chain activity.

Further, I'm pleased to report that our cross-selling efforts have yielded our first bookings for our Embedded Power products for use in auxiliary power applications in wafer fab equipment. This win gives us the confidence that over time, we will gain share in this $170 million new market opportunity. As we go through 2020, I'm increasingly confident in our ability to deliver on our target synergies and to create value to all our stakeholders.

In summary, I'm very excited that our Q4 performance ahead of expectations, our design win successes, the strong execution of our operating team and the solid progress we are making in integrating Artesyn Embedded Power. While the coronavirus is impacting our operations and supply chain in the near term, demand from our market is strengthening, driven by the growing need for solutions that enable the Fourth Industrial Revolution.

Our continued focus on enabling our customers' innovation through our technologies and products is driving our growth pipeline of design wins and contributing to our revenue growth. Our strategy to be the pure-play leader in precision electrical power is resonating with our customers. We are executing our profitable growth plans by targeting growth markets, gaining share across our verticals and expanding into new and exciting opportunities. All these position us to deliver meaningful growth in revenue and earnings in 2020.

I'd like to thank our customers, shareholders, partners and our valued employees for your support. I look forward to seeing many of you in the upcoming quarter. With that, let me turn the call over to Paul. Paul?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

Thank you, Yuval, and good morning, everyone. Total revenue for the fourth quarter of 2019 was $338 million, up from $175 million in Q3, which only included a partial month of Artesyn. Excluding Artesyn, organic revenue grew 18% sequentially and 3% year-over-year to $159 million. On a pro forma basis, including a full quarter of Artesyn revenue in prior periods, Q4 revenue grew 17% sequentially and 8.5% year-over-year driven by strong growth in Semiconductor Equipment and Data Center Computing.

For the full year 2019, we recognized record revenues of $789 million, reflecting 9.7% growth over 2018. Excluding Artesyn, our 2019 revenues were $569 million, down 21% from 2018, primarily due to the downturn in the Semiconductor Equipment market in the first 3 quarters of the year and ongoing macro weakness affecting our industrial products.

Before I talk about our sales by markets, I want to note that my forward-looking comments for Q1 reflect our demand outlook, not revenue. I will cover our revenue outlook at the end of my comments given the potential impact on our operations of the evolving situation in China.

Semiconductor Equipment revenue for Q4 was $125 million, up 30% from last quarter and 16% year-over-year. On a pro forma basis, semi revenues were up 28% sequentially, driven by 41% sequential growth in semi product sales. We saw continued growth in OEM demand, driven by investment in foundry/logic, some recovery in memory and incremental contribution from our prior design wins.

For the year, semi revenues were $403 million, down from $534 million last year. Looking to Q1, we expect demand in semi to grow sequentially in the mid-teens, with growth from both foundry/logic and memory applications. This outlook would represent year-over-year growth of greater than 45%.

Revenue from Industrial & Medical markets was $97 million, up significantly sequentially and year-over-year due to the addition of Artesyn. On a pro forma basis, revenues were down less than 1% sequentially. During the quarter, we saw continued macro weakness in several of our industrial sectors, but we were able to largely offset these macro trends with shipments of specific programs resulting from prior design wins for both existing and new embedded power products. Artesyn products contributed $61 million of sales into the Industrial & Medical markets in Q4, which was up 3.3% from Q3 on a pro forma basis.

For the full year, Industrial & Medical revenues were $246 million, up from $185 million in 2018. Excluding Artesyn, 2019 revenues were $169 million, with a decline due mainly to weaker demand in flat panel display, consumer electronics-related decorative and optical coatings and glass manufacturing in Europe and China. Looking to Q1, we expect demand from this market to be down sequentially on normal seasonality and the absence of the onetime projects in Q4.

Data Center Computing revenue was $78 million, with significant growth versus the partial quarter recorded in Q3. On a pro forma basis, revenues were up about 70% sequentially and 27% year-over-year based on the significant share gains, particularly in hyperscale that Yuval discussed earlier. In Q1, we expect demand to show modest sequential growth from the record Q4, with continued strength in hyperscale, offset by seasonally lower demand from enterprise computing customers.

Telecom & Networking revenue was $38.5 million. On a pro forma basis, revenues declined about 20% from Q3, which was in line with our expectations and the commentary last quarter. Looking forward, we expect continued pressure in this market with demand bottoming out in the next 1 to 2 quarters.

With our new market disclosures, service revenues are counted within our 4 market verticals. But on a stand-alone basis, our Q4 service revenue was $26.7 million, down slightly from Q3. For the year, our service revenue grew 2% to $111 million. However, if we exclude the central inverter service business that we sold in May of 2019, revenue grew 7% for the year despite lower factory utilization by our customers.

Gross margin for the quarter was 33.2%. Cost of sales included approximately $6.8 million of acquisition-related charges and $2.2 million of facility expansion and relocation costs primarily related to our strategic investment in the Malaysia factory. On a non-GAAP basis, gross margin was 35.9%, which is at the high end of our guided range. Gross margins benefited from lower fixed cost absorption on higher revenue and lower warranty costs.

Looking to Q1, we expect adjusted gross margins to be in the 34% to 36% range. GAAP operating expenses in Q4 came in at $90 million, including $5.3 million of intangible amortization, $2.6 million of acquisition-related charges, $2.1 million of stock compensation and $2.1 million of restructuring and transition expenses.

In addition, in Q4, we recorded a onetime reserve of $4.2 million for doubtful accounts related to our exposure in China to certain program delays and business conditions that have been further impacted by the coronavirus. This is reflected in both our GAAP and non-GAAP operating expenses.

Non-GAAP operating expenses were $78 million. If we exclude the onetime reserve, our non-GAAP operating expenses came in below the low end of our guidance range on good expense control and initial synergy savings. Looking forward, we expect adjusted operating expenses in the first quarter to be between $73 million and $77 million.

GAAP operating margin for the quarter was 6.6%. Non-GAAP operating margin was 12.8%. Non-operating expenses on a GAAP basis came in at $4.8 million. On a non-GAAP basis, nonoperating expense was $3.8 million, made up of $2.3 million of net interest expense plus $1.5 million in foreign exchange loss and other items. Looking forward, we expect nonoperating expense to run in the $1.5 million to $2 million range.

In Q4, we recorded GAAP tax expense of $6.9 million or 40%, higher than normal due to nondeductibility of certain transaction costs. Our non-GAAP tax expense was $6.2 million or 16%. Looking forward, we expect our GAAP and the non-GAAP tax rate to be in the range of 16% to 18% with the addition of Artesyn.

On a GAAP basis, earnings per diluted share from continuing operations were $0.27 compared to earnings of $0.19 last quarter and $0.50 last year. Non-GAAP EPS for the quarter was $0.87, above the high end of our guidance due to higher revenue, favorable gross margin and good expense management. This compares to $0.54 in the prior quarter and $0.73 a year ago.

Turning now to Artesyn. Q4 was the first full quarter of integrating Artesyn, and the team has done a great job accelerating our efforts to realize the synergies of this acquisition. As of the end of Q4, we have realized synergies equivalent to over $10 million on an annualized basis. Combined with our strong performance in Data Center Computing, Artesyn was solidly accretive in Q4, adding more than $0.20 per share to our non-GAAP earnings, including the interest expense of financing. While the level of accretion will fluctuate from quarter-to-quarter, we remain confident that we are well on our way to achieve our 18 to 24-month target earnings accretion of over $0.80.

Turning now to the balance sheet. Operating cash flow from continuing operations was approximately $19 million, which includes several onetime payments related to the Artesyn acquisition. Excluding these onetime payments, operating cash flow was over $45 million. We ended the quarter with cash and marketable securities of $349 million, up $8 million from Q3. Total debt was $339 million after amortization payments on the loan. Receivables decreased slightly, and DSO was 66 days. Inventory decreased by $11 million, and turns were 3.9x. Payables decreased to $170 million due to timing of receipts and payments and represent 68 days DPO.

Capital expenditures for the quarter were $9.5 million, and depreciation was $5.5 million. The higher capital expenditures reflects a full quarter of Artesyn CapEx as well as increased investment related to the new manufacturing facility in Malaysia. During the quarter, we did not repurchase any shares.

Now let me turn to guidance. Looking forward, we continue to see strong demand for our products and expect sequential growth in orders in Q1, led by semiconductor and data center markets. In addition, while visibility is low in the second half, we are encouraged by recent projections for improvement in our markets and believe that overall 2020 will be a solid growth year in both demand and revenue on an actual and pro forma basis. In the near term, we expect revenues to be impacted by the challenging environment in China related to coronavirus. As a result, we estimate revenues to be $310 million, plus or minus $30 million in Q1.

We estimate Q1 non-GAAP earnings at $0.70 per share, plus or minus $0.30. Due to the uncertainty created by the novel coronavirus outbreak, we are providing a wider guidance range based on our team's current assessment of our supply chain, product delivery and production planning. In the near term, we expect to see some increased costs for expedite fees, transportation and factory utilization as we actively work with our suppliers and customers to mitigate the challenge and fulfill our increasing backlog.

As a note, given our China footprint, we expect Artesyn products to be relatively more impacted and to represent just under half of our guided Q1 revenue, but to still be accretive to non-GAAP earnings. I want to stress that demand for our products is strong, continues to grow and above our revenue guidance. Although the coronavirus is disrupting our supply chain in the near term, we believe continued recovery in our markets, our increased revenue diversity and success in securing additional design wins should mitigate the near-term impact and still enable solid growth year-over-year for 2020. Combined with our efforts to realize synergies, we expect to accelerate earnings growth and improve return on invested capital over time.

With that, we will open the call to your questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Quinn Bolton with Needham & Company.

Quinn Bolton - *Needham & Company, LLC, Research Division - Senior Analyst*

Congratulations on the strong fourth quarter results. Thanks for all the qualitative color around the impact near-term on the coronavirus, but wondering if you might be able to give us some sense of how much you shaved off the March quarter guide due to the outbreak? If I look through your segments, semi cap equipment and data center both being up -- or demand for both segments being up sequentially makes me think that you could have easily shaved $20 million or $30 million off of the March quarter guide. Is that the right kind of ballpark to be thinking about?

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

Quinn, this is Yuval. Yes, pretty much. Let me expand a little bit on the coronavirus. We view that as a temporary situation. Obviously, it's evolving daily with high level of uncertainty, but we are highly confident in our team's focus and strong execution and our nimble and agile operation. We have opened our Chinese factories and actively managed our supply chain and operational risks.

Many of our suppliers in China have just reopened the factories yesterday, February 17, while some have not restarted yet. We are implementing different solutions to expedite delivery of materials, to the comment that Paul said earlier, and components through alternative channels and transportation means. We're accelerating the return of direct labor to work in ramping up production capacity in factories outside of China.

Our strategy to have multiple-factory strategy around the globe is helping us as we have capacity in Malaysia and the Philippines. Some of our support functions are uninterrupted because people work from home. People like demand planning, management, et cetera, working from home. So again, we view that as a temporary problem, and we start seeing signs of recovery.

Quinn Bolton - *Needham & Company, LLC, Research Division - Senior Analyst*

Great. And I just have a follow-up for Paul. The gross margin guidance of 34% to 36% sounds like it doesn't include some sort of near-term effect from the virus. You mentioned the expedited fees. Can you give us some sense, is that impact 100 basis points -- or any further guidance you can kind of give us as to the near-term impact from some of those expedite and other costs you're incurring because of the coronavirus?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

Yes. I think, obviously, gross margin is amalgamation of a lot of factors, right? And certainly, our semi demand is strong and will benefit the mix a little bit in the next quarter. But broadly speaking, there's probably a 50 to 100 basis point impact from just inefficiencies associated with the coronavirus that's baked into that number.

Quinn Bolton - *Needham & Company, LLC, Research Division - Senior Analyst*

Great. And then the last question for me, Yuval. Yesterday, The Wall Street Journal published an article saying that U.S. Commerce Department may be looking to change the foreign direct product rule and require export licenses for semiconductor capital equipment to worldwide fabs. I know this is sort of very recent news, but have you considered what impact such a change in the foreign direct product rule might have on your business? Or is it too early to quantify?

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

Quinn, right now, we don't believe that this will impact us significantly.

Operator

Our next question comes from Tom Diffely with D.A. Davidson.

Thomas Robert Diffely - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

First, Paul, a question on the backlog. It looked like it was down about 11% sequentially. I would have thought that this is the time of the year where where you'd be ramping up ahead of a nice semi ramp here?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

Yes, Tom, one thing you have to remember is our backlog is only a partial reflection of our orders because the vast majority of our semi product is pulled on adjusted time basis. And so that activity is not reflected in the backlog.

Thomas Robert Diffely - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

Okay, makes sense. And then, I guess, you're talking about the semi demand that you're seeing right now. Are you seeing -- is your demand close to equaling what you think the end market demand is? Or are you actually seeing your customers start to build some inventory ahead of their ramps?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

Well, I wouldn't say we're seeing our customers build inventory, although the pull rates in December, I think, were strong, as you saw from our revenue. But I think that, overall, the market is up. And we're growing faster than the market for a number of reasons. One, I think we have good exposure to foundry/logic, which is what's driving a lot of the demand right now. Secondly, we have seen incremental benefit from some of our design wins that we've talked about over the last few quarters. And third, we had a headwind last year relative to inventory at our customers. That basically also drove Q3. So we're not seeing that headwind anymore, which is giving us effectively the benefit of faster growth in the market, where, last year, we saw the other side of that.

Thomas Robert Diffely - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

Okay. And then also, you talked about 20% contribution from Artesyn. That's a little bigger than we were expecting. Was there more to it than just the nice ramp on the data center side? Or is it the cost reduction? What drove the upside there?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

Well, it is a combination of things, and it's $0.20 is what we said.

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

$0.20, right?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

$0.20 of incremental EPS or accretion, that's after the finance interest costs. But yes, it is -- we've seen good revenue pickup. We've also been able to see the initial benefit of some of the synergies that we've implemented. We're at an annualized rate of savings coming out of Q4 of a little over $10 million, which we think is directionally right on track to achieve our longer-term goals. Those are coming from a number of actions we're able to take right off the bat around corporate costs, some initial structuring -- restructuring that we did, some actions that we took in the sales channel to get some efficiencies. So we are seeing the culmination of those things leading to the benefits that you see there in the accretion. We're excited. I think we're off to a good start, and we're especially excited about how the organizations are coming together and working together right out of the bat.

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

Tom, the other great news about the Artesyn acquisition, we already started generating bookings from the semi wafer fab equipment industry for the Artesyn products. And these cross-selling opportunities that we talked about as a potential revenue synergy is coming faster than and earlier than we thought. So this is really exciting.

Thomas Robert Diffely - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

Okay, great. And then, finally, when you look -- I guess, you talked a lot about how the supply chain was impacted by the coronavirus. What about -- what are you seeing on the demand side? Any disruptions there?

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

We -- go ahead.

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

Yes. I think it may be too early to see that impact, but we certainly have seen no change in sort of the demand pattern that we saw coming out of Q4 and into Q1. As Yuval mentioned, we've seen a strong start to the quarter, and I think the demand picture continues to be robust.

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

The demand continues to be strong and robust. We do not see any additional demand driven by concern about allocations or shortage. We just see healthy demand driven by market needs, in semi, for example, one area; Data Center Computing, another area.

Operator

Our next question comes from Krish Sankar with Cowen and Company.

Krish Sankar - *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

Yuval, I just want to go back to one of the earlier questions on The Wall Street Journal article speculation. You said that you see minimal impact. I'm kind of curious, is that answer more based on you talking to your customers? Or -- I'm just kind of curious like why you think there's only a minimal impact for the sector, if that article is true.

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

It -- this is based on our assessment on -- and knowledge of our customer base and where we sell. Obviously, we did not talk to our customers since The Wall Street Journal article was published. As you know, we sell worldwide. We are manufacturing worldwide. We have customers around the globe. And right now, when it comes to the near term, we don't see any significant impact on our business. Long term, we don't know.

Krish Sankar - *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

Got it. Got it. That's very helpful, Yuval. And then just a question on your facilities in China. You said that it is open, but the production output is affected. I'm kind of curious, what is the bottleneck? Is it really labor, getting all the people on board and like trying to ramp up the factory? Or what is the bottleneck in that supply chain ramp up? And typically, how long will it take to ramp it up to 100% utilization?

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

So it's a combination of practically 3 drivers. The first driver was basically immediately after the Chinese New Year and the extended length of the holiday by the government is the rate of return of employees back to the companies and back to the factories. And it was driven by limitations of transportation vehicles and means of transportation, areas in China that was under quarantine by the government. And the rate of return was also controlled by the government locally that wanted to ensure that factories are safe for the employees.

And the safe -- the health and the well-being of our employees is the #1 priority. And we've put together significant measures and means to ensure that this -- health of our employees is protected. So the rate of return -- and it's ramping. We see growth in the number of people that are going back to work across our factories.

The other area is supply chain. As I said earlier, some of our suppliers are back to work, full -- not full capacity. Some of them are ramping. And there are small suppliers especially closer to areas that are in the epicenter that haven't started yet. We are working closely with our suppliers. We are also working with hubs and inventory that is in the pipeline and the channel to ensure that we can get that inventory into our factories.

And lastly, the third aspect is the ability to move material around in various transportation means. And when we talk about expediting fees and investment in other ways and means to get material, it's exactly that. How do we reroute material in channels and in transportation means that will ensure that we get the material to the factory, so it's multifaceted.

Krish Sankar - *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

Yuval, just one final question. It's very nice to see the Malaysia facility ramp up. But with the virus, does this delay your China facility consolidation or do you think that's still for time line?

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

No, it's totally independent. In fact, we were in the process of ramping our Malaysia factory. And because of this coronavirus situation, we are accelerating the ramp of the Malaysia factory. Obviously, we also need to remember that some of the supplies that go into the Malaysia factory come from China. So it's basically a very carefully planned and executed strategy around how to get material, how to get labor and how to ramp. We are shipping products from the Malaysia factory to our global customers.

Operator

Our next question comes from Amanda Scarnati with Citi.

Amanda Marie Scarnati - *Citigroup Inc, Research Division - Semiconductor Consumable Analyst*

Just going to continue on to the coronavirus. Hopefully, this is the last question on it. Could that undershipment of demand be met in the June quarter? Or is this sort of a longer-term trajectory of rebuilding up demand, i.e., do you have the capacity in your fabs to ramp at a significantly higher rate in the June quarter?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

Yes. I think at this point, Amanda, the environment continues to evolve. It's fairly uncertain how fast things can ramp back up. But we think it would probably realistically take a couple of quarters before we would see a full recovery. That could be a little longer, a little shorter, depending on how fast things come back. But there's a lot of variables we don't know at this point.

Amanda Marie Scarnati - *Citigroup Inc, Research Division - Semiconductor Consumable Analyst*

And then you mentioned in the Telecom & Networking, that the demand is down in the March quarter. You expect another 1 to 2 quarters of continued pressure before that business bottoms. Can you talk about what you're seeing there? And sort of what gives you the confidence in potentially the back half of the year that you can start to see some revenue recovery?

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

Well, I think we're entering potentially to the bottom of the market within a quarter or 2, and this is mainly driven by multiple factors. First of all, as you know, that the consensus out there is that the market will recover later this year, and we tend to agree with that. We saw a delay of investment in infrastructure around 5G. There's a lot of combination of government and industry forces acting upon the infrastructure investment in 5G, the use of LTE-Advanced for 5G applications pushed the investment further out. There's some government involvement around 5G investment, as you heard from the U.K. and other areas. And also, the impact of the Huawei situation may also impact the the global market.

We are well positioned to serve this 5G and telecom market when the market recovers because of our strategic relationships, very close relationship with some of the leading companies that make those radio towers and the infrastructure. So there's no doubt in our mind that we will see that recovery. And when the market recover, we expect to benefit from that.

Amanda Marie Scarnati - *Citigroup Inc, Research Division - Semiconductor Consumable Analyst*

And then just following up on that, can you comment on what your exposure to Huawei is? And if there would be an impact if, given the [Moore's] rule, that's reduced to 10% versus 25%?

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

Huawei is a small customer of ours, very small volume, and we serve this customer through our engineering teams and manufacturing in Asia.

Operator

Our next question comes from Pavel Molchanov with Raymond James.

Pavel S. Molchanov - *Raymond James & Associates, Inc., Research Division - Energy Analyst*

You mentioned that the legacy Artesyn business is more exposed to the coronavirus uncertainty than the legacy AE business. Why exactly is that?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

Well, we mentioned already that one of the large factories for Artesyn is in China, and so there's exposure there. But I would say, on balance, the supply chain in Artesyn, because of the nature of the products, is more China-based as well. So it's the combination of those 2 things.

Pavel S. Molchanov - *Raymond James & Associates, Inc., Research Division - Energy Analyst*

Okay. And balance sheet question. Your net leverage very quickly turned negative, as it has been, obviously, for many, many years. Is debt reduction still a priority for you to bring down that $339 million of debt?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

It is, Pavel. Obviously, we've been making amortization payments. So it's a -- the debt is already down $11 million from 5 months ago, 4 months ago when we took the debt out. But as we continue to see sort of healthy cash generation, that's our #1 priority, is debt reduction. And this quarter, our operating cash flow was about $19 million. Total cash increased about $9 million. But underneath that, we had a lot of deal-related cash costs.

We had some -- we paid a lot of the acquisition-related fees. And as part of the transaction, we assumed a number of payables from the legacy company of Artesyn, and those were all paid down. So if you exclude those items, our underlying cash flow was over $45 million. We think that's very encouraging and should give us a lot of leverage going forward. By the way, I just want to note that our net cash was actually positive in Q4. It was negative in Q3, but in Q4, the combination of the higher cash balance and the payment on the debt did move it to positive this quarter.

Operator

Our next question comes from Patrick Ho with Stifel.

Brian Edward Chin - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

It's Brian actually calling in for Patrick. A couple of questions. Maybe, first, on the semi cap business, just to go back to a line of questioning and just to clarify. It sounds like your semi cap shipments in Q1, you're saying they should be sequentially maybe flat to down 10% versus what you think the organic demand is. I just want to clarify that sort of ballpark. And then also, in light of what's transparent, I'm wondering if you think your customers are going to naturally request to add maybe a buffer stock layer here, given sort of just from a supply chain sort of safety of supply standpoint?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

Yes. Thanks, Brian. First thing, thanks for asking the clarifying question. We didn't actually say by market how the demand would be impacted, other than that Artesyn would be impacted or the embedded power products would be impacted, we think, slightly more. Broadly speaking, I think our -- the demand pattern will somewhat drive the underlying revenue. So I think those proportions probably hold. And we expect semi to be up, which means they're relatively less impacted if you look sequentially. The second...

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

Well, our customers in semi, as you know, they pull material when they need it from our just-in-time inventories. And our just inventory -- just-in-time inventories have bins with inventory in them, and this inventory acts like a buffer.

Brian Edward Chin - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

And just -- I've a question about data center. But just -- it sounds like in the semi cap business, between foundry/logic memory, do you think there's any more impact near term if it takes maybe a quarter or a couple of quarters to sort of catch-up there? And any one particular area that might be more impacted?

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

I don't think we can answer the question.

Brian Edward Chin - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

Okay, fair enough. And data center, is there a way of -- obviously, even on a pro forma basis, nice sequential jump there in Q4. Is there a way of characterizing what your revenue and/or growth in Q4 might have been for data center, excluding the share gains? Just kind of trying to understand what the natural market growth rate might have been?

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

Hold on a second.

Yeuk-Fai Mok - *Advanced Energy Industries, Inc. - VP of Strategic Marketing & IR*

Hey, Brian, this is Edwin. Just to kind of give you some color on the data center, right? We'll quantify the majority of the gain -- growth we got sequentially, the 70% sequential growth that we talked about, vast majority of it is due to share gain.

Brian Edward Chin - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

Vast majority is share gain...

Yeuk-Fai Mok - *Advanced Energy Industries, Inc. - VP of Strategic Marketing & IR*

Yes, as we said, one, we had a Tier 1 hyperscale customer that ramped. That is a new customer.

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

So let me give you a little bit more color. The data center hyperscale, obviously, an important part of the business, over the last 18 months, 24 months, the company had put significant effort in getting design into the hyperscalers. We view that the hyperscale part of the Data Center Computing is the fastest-growing segment. And for that reason, a significant effort was put in gaining share in the hyperscale part of the business. So most, if not all, of this increase, giant increases, 70% increase in Data Center Computing business is a result of these recently won design wins that are converted to mass production in high-volume shipments.

Brian Edward Chin - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

Okay. And obviously, you expect a lot of strength in Q1 as well. And I know you've referenced, I think, sort of a lumpy business. Is there a way from a baseline perspective, maybe from a client perspective, what you think the TAM there might grow in calendar '20? Obviously, you guys probably are going to grow well ahead of that. But a way kind of a baseline there, I don't know if you want to bifurcate it by sort of hyperscale versus enterprise or cycle?

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

Yes, I don't think -- I don't have the answer right now for that, Brian. And we can get back to you with that.

Brian Edward Chin - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

Okay. No problem.

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

Right now, we believe we grow faster than the market, and mainly because of those design wins and share gain that allows us to accelerate. We say that hyperscale will grow at about 15% CAGR, but that the TAM will be flattish, right? So we can get back to you.

Brian Edward Chin - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

It sounds like based on sort of the way your supply chain is oriented and where demand is coming from, that doesn't seem like it's necessarily impacted from sort of the China effects?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

I wouldn't say that. I think that -- I think the China coronavirus effect impacts all our products.

Brian Edward Chin - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

And just to be clear, the China coronavirus effect, we think, is a temporary effect. It's affecting our ability to eke output out of the factory in the near term. We don't see it having a longer-term effect on any of these markets at this point. And it's just a matter of how quick things come up then we can get things converted, and then how quickly we basically fill that gap between essentially backlog or demand and the output we're able to achieve in the near term.

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

We're very excited. We're very excited with the continuous growth in demand for our products across the markets we serve. We need to go through this short-term situation in China before we recover.

Operator

Our next question comes from Mehdi Hosseini with SIG.

Mehdi Hosseini - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Yes. A couple of follow-ups. Yuval, it's been almost 2 months since your Analyst Day, and I'm just wondering if you have any additional thoughts on the core semi cap. How do you see the market evolving throughout the year, excluding the coronavirus? And how is that different than your thoughts back in mid-December when you had your Analyst Day? And I have a couple of follow-ups.

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

Mehdi, I think the general consensus has become more constructive since our Analyst Day. We saw the market becoming more bullish around added capacity, not only in foundry and logic but also in memory. And for us, obviously, good news because we are quite balanced in the way we serve the market, both in foundry/logic and memories. Without the impact of the coronavirus, which we believe is a temporary bump in the road, we would assume that 2020 will be slightly better than we thought originally.

Mehdi Hosseini - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

So there's more of increased diversification in end market demand drivers. Like, this is not just foundries, now you're beginning to see a pickup in memory. Is that correct?

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

Correct. Correct.

Mehdi Hosseini - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

All right. And then just one follow-up...

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

And by the way, with that, Mehdi, we see some additional investment driven by new technology, advanced technology, new materials, new processes.

Mehdi Hosseini - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Sure. Did you say that -- in your prepared remarks, did you say that the semi cap revenue will be up mid-teens in March versus December?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

We said that demand up mid-teens sequentially in the current quarter versus Q4.

Mehdi Hosseini - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Okay. But you had...

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

That's the rate of demand. Yes, good catch, Mehdi. Demand is up mid-teens in March. Obviously, our ability to deliver to this demand is temporarily affected by the coronavirus situation in China, but the demand continues to be strong.

Mehdi Hosseini - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Sure. I get it. But my question here is, let's say, $130 million plus/minus, as to how I come up with the March quarter revenue attributable to Semiconductor Equipment. What I want to learn more is, how do you see this cycle playing out in the next 2 years? In the past, in the prior cycle, in the 2016 and '17, you benefited from a multiplier because of 3D NAND. And now as you look forward, the 3D NAND is still there. Now you have additional layers for DRAM and you have a foundry. Are we still going to be looking at the past and thinking about a 2 to 3x multiplier factor? And that's how we should model this for the next 2 years? Or do you have any other thoughts you can add to it.

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

So let me give you a high level kind of a quoting consensus -- opinions. And then maybe talking about what we saw up 2, 3 years ago when the industry converted to 3D NAND. So right now, I think the consensus is that 2020 will be a growth year, and 2021 will be a very strong growth year. So that's the general consensus, right? And we were not market forecasters, so we basically look at what we hear and register that general information.

Now in the year '16, '17, '18, first half, what we saw was a conversion of an industry from planar to 3D memories, especially NAND. That level of multiplication was driven by additional capacity, greenfield fabs and also the fact that yields were relatively low. We believe that the industry became more efficient, yields are higher and the additional capacity, especially greenfield, will not be at the level we saw at '16, '17, the first half of '18. That's the only commentary I can give you. Again, we're not market forecasters. However, as we have demonstrated, we will still grow faster than the market we serve, as we have done in the past.

Mehdi Hosseini - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Sure. Just quickly switching to Paul. If your initial assessment were to play out, and you see that second half uplift, especially as some of the revenue from the first half pushed out to the second half, should we expect the absorption and gross margin recovery would get you into the 40s?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

No. I think that would be too aggressive. Certainly, our long-term goal is to get margins up to the 40%. But that's on a fully synergized basis, and with revenue levels that start to approach the $1.4 billion, $1.5 billion range, Mehdi. But certainly, as volume picks up, we get efficiency improvements. And we are actively working on implementing the synergies over time. So certainly, our goal would be to continue to bring that margin up. But that would be too fast to check to get to that level in the second half. I'd say maybe, broadly speaking, there will be modest improvement in that direction, but certainly not getting to that level.

Mehdi Hosseini - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Okay. And how should we think about Opex? Where would it go from $75 million? Am I making any point?

Paul R. Oldham - *Advanced Energy Industries, Inc. - Executive VP & CFO*

Yes, broadly speaking, as revenues pick up, we'll see some modest increase in variable cost. But we don't -- we didn't make a lot of structural reductions during downturn. We don't have to make a lot of structural adds going forward. So I think broadly around this level, with some modest variable cost pickup, it's probably the right way to think about it.

Operator

And I'm not showing any further questions at this time. I'd like to turn the call back to Yuval for closing remarks.

Yuval Wasserman - *Advanced Energy Industries, Inc. - President, CEO & Director*

Thanks, everybody, for joining us today. We are extremely excited about the integration of Artesyn and the future of the company. We view the coronavirus situation as a temporary bump in the road. We are seeing increased demand for our products from various end market verticals, and we're ready to serve those markets as soon as we can in terms of our operation in China. I'm looking forward to seeing many of you during the quarter. Thanks.

Operator

Ladies and gentlemen, this does conclude today's presentation. You may now disconnect, and have a wonderful day.