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ANEN.O^B14 - Q4 2003 Anaren Inc. Earnings Conference Call

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OVERVIEW:

During FY03, the co. purchased 643,000 treasury shares in open market at an avg. cost of \$8.37. Cash, cash equivalents and investments were approx. \$128m at June 30, up \$3m from June 30 of 2002. The co. believes net sales for 1Q04 will be in the range of \$17-19m. Q&A Focus: Wireless market, Celeritek situation, guidance, and defense side.



CORPORATE PARTICIPANTS

Larry Sala *Anaren - Chairman and President and CEO*

Joe Porcello *Anaren - VP Finance*

CONFERENCE CALL PARTICIPANTS

Rich Valera *Needham and Company - Analyst*

Sandy Harrison *Pacific Growth - Analyst*

JD Abouchar *Pacific Edge Investment Management - Analyst*

Kevin Dede *Marilyn and Company - Analyst*

George Iwanyc *CIBC world Markets - Analyst*

PRESENTATION

Operator

Good day, everyone, and welcome to the Anaren fourth quarter earnings release. Today's call is being recorded. At this time, for introductions and opening remarks, I would like to turn the call over to Mr. Larry Sala, President and Chief Executive Officer of Anaren Incorporated. Please go ahead, sir.

Larry Sala - Anaren - Chairman and President and CEO

Thank you. Good afternoon and thank you for participating in the Anaren fiscal 2003 fourth quarter conference call. I'm joined today by Joe Porcello, our Vice President of Finance. I will provide an overview of the results of the fourth quarter and fiscal year ended June 30th, 2003, after which Joe will review the financial highlights. We'll then take your questions.

The statements contained in this conference call which are not historical information are forward-looking statements. These statements involve risks and uncertainties that could cause actual results to differ materially from those discussed. You are encouraged to review Anaren's fourth quarter press release, Anaren's form 10-K for the fiscal year ended June 30th, 2002 and 2003, Anaren's form 10-Q for the third quarter ended March 31st, 2003, and exhibits to those reports filed with the Securities and Exchange Commission to learn more about the various risks and uncertainties facing Anaren's business and their potential impact on our net sales, earnings and stock price.

Net sales for the fourth quarter \$19.4m, up slightly from net sales of \$19.2m for the third quarter of fiscal 2003. That loss for the quarter was \$3.5m compared to a net loss of \$1m for the third quarter of 2003. The net loss in the fourth quarter included a net loss at [inaudible] Europe of \$3.9m, of which \$1.4m is attributed to the restructuring charge for the work force reduction and \$2m which is a fixed asset impairment charge due to the previously announced decision to dispose of our Anaren Europe operation. Anaren Europe net sales for the quarter were \$900,000 and are included in our Wireless Group net sales.

Excluding the results of Anaren Europe, net sales for the fourth quarter were \$18.5m, the net income for the quarter was \$440,000 or \$0.02 per diluted share.

The decision to dispose of Anaren Europe resulted from the decline in revenue and the continuing financial losses of that operation, despite efforts to capture new business, new orders at Anaren Europe have been negatively impacted by the continued overcapacity in the printer circuit board industry, the desire of our wireless customers to source this type of technology in Asia and also negatively impacted by the appreciation of the euro. It's anticipated that Anaren Europe operations will cease during the current first quarter and that the liquidation of assets will take place during the second and third quarters of this fiscal year. We believe that the cash generated by the liquidation of Anaren Europe assets will be sufficient to fund the expenses incurred in disposing this operation.



Wireless group net sales for the quarter were \$12.7m, up 9% sequentially from the third quarter. Wireless market demand remains weak and visibility still remains limited and sequential growth in wireless net sales was driven by increased demand for our backplane and resistive products. We continue to benefit from our broad market penetration and our customer diversity. From our customer concentration standpoint for the wireless group as percentage of wireless group net sales; Motorola was 15%, Ericsson was 14%, PowerWave (ph) was 11% and Lucent was 5% during the quarter. We believe the 802.11 Femto series balance product line that we introduced in the third quarter has been positively received in the marketplace. To date we have achieved reference design wins with four leading chip manufacturers and continue to invest in new product development to expand our 802.11 product offering as well as our dollar content.

For the Space and Defense Group, net sales for the fourth quarter were \$6.7m, down 8% sequentially from the third quarter of fiscal 2002. Space and Defense Group new orders for the quarter were \$4.2m, including follow-on orders for ground-based radar antenna distribution networks, as well as our airborne location subsystems. Space and Defense backlog at June 30th, 2003 was approximately \$26.3m. Joe Porcello will now review the financial highlights. Joe.

Joe Porcello - Anaren - VP Finance

Good afternoon. The financial highlights of the fourth quarter income statement and the balance sheet at June 30, 2003, are as follows. The gross profit margin for the fourth quarter of fiscal 2003 was 24.6%, 160 basis point decrease from gross margins of 26.2% in the third quarter of fiscal 2003. Gross margins declined due to the inventory write-down included in cost of sales as part of the restructuring in the fourth quarter at Anaren Europe. Going forward in fiscal 2004, we expect to see some improvement in gross margin as a result of our past and ongoing cost-cutting efforts.

Investment in R&D was 7.3% of net sales in the fourth quarter of 2003, compared to 9.3% in third quarter of fiscal 2003. R&D expenditures have declined in both actual dollars and as a percent of revenue from third quarter due to amplification of additional engineering personnel to work on customer-funded design opportunities. The impairment loss and restructuring charges in fourth quarter of fiscal 2003 totaled \$3.9m, compared to \$1m in third quarter of fiscal 2003. The amount of impairment loss and restructuring charge related to the anticipated disposition of our European subsidiary was \$3.4m and included an impairment charge of \$2m, a restructuring charge and cost of sale of \$428,000 and operating restructuring charge of \$1m. The loss from operations was 20.5% of sales in fourth quarter of fiscal 2003 compared to loss of operations of 7.8% of sales for the third quarter. Operating margins decreased due to \$3.4m restructuring and asset impairment charge reported in fourth quarter related to the anticipated disposition of Anaren Europe.

The company is continuing to review all opportunities to reduce cost whenever possible. These reductions are expected to provide improvement in fiscal 2004 operating margins despite anticipated lower sales levels. The net loss was 7.8% of net sales for the fourth quarter of fiscal 2003. This compares to net loss of 5% of net sales for the third quarter. On per share basis, the diluted per share for the fourth quarter of fiscal 2003 was \$0.16, this compares to loss of \$0.04 per diluted share in the third quarter. Excluding the results of Anaren Europe net sales for fourth quarter were \$18.5m and net income was \$440,000 or \$0.02 per diluted share. It is anticipated that Anaren Europe will cease manufacturing operations in the current first quarter of fiscal 2004 and that the liquidation of assets will take place during quarters two and three. All revenue expenses associated with this operation will be reported in the future on one line as a result from discontinued operations as required by GAAP. Income statement detailing the loss of Anaren Europe and results for fourth quarter and year, excluding Anaren Europe is included in today's earnings release.

The balance sheet highlights include the following. Cash, cash equivalents and investments were approximately \$128m at June 30, up \$3m from June 30 of last year. Despite the loss we have continued to enjoy positive cash flow from operations in fiscal 2003. Cash generated by operations was approximately \$12.2m in fiscal 2003 and came in part from \$4.4m reduction in inventory and \$3.8m reduction in accounts receivable. Accounts receivable were \$9.3m at June 30, 2003, down \$3.8m from June 30, 2002. Days sales outstanding at end of June were 44 days compared to 56 days at end of June, 2002. Despite the large drop in DSO during the quarter, we continue to expect DSO to fluctuate between 50 and 70 days as we go forward, depending on sales levels, customer mix and business conditions. Inventories at June 30, 2003 were \$15.7m, down \$4.4m or 22.1% from \$20.1m at June 30, 2002. Capital equipment additions in the fourth quarter of 2003 amounted to approximately \$600,000. The additions were mainly for production equipment at our East Syracuse facility to support a new military satellite program. Accounts payable at June 30, 2003 were \$4.6m down \$400,000 from June 30 last year reflecting the decline in material purchases. During fiscal 2003 we purchased 643,000 treasury shares in open market at average cost of \$8.37. It is anticipated that we will continue to make open market purchases of shares for treasury under the current forward authorization depending on market prices.



Larry Sala - Anaren - Chairman and President and CEO

Thanks, Joe. Going forward as Joe stated, reported net sales will exclude Anaren Europe and the operation will be reported as a discontinued operation. Given the current uncertain wireless market conditions and the expected loss from discontinued operations at Anaren Europe in the first quarter of approximately \$900,000, we believe first quarter net sales will be in the range of \$17m to \$19m and earnings per share will be in the range of negative \$0.01 to positive \$0.02. We will now take questions.

QUESTIONS AND ANSWERS

Operator

Thank you, sir. If you would like to ask a question, please do so by pressing the star key followed by the digit 1 on your touch-tone telephone. If you are on a speaker phone, please be sure the mute function is turned off to allow your signal to reach our equipment. Once again, press star 1 on your touch tone telephone to ask a question. We will pause for just a moment to give everyone an opportunity to signal for questions. We will take our first question from Rich Valera of Needham and Co. Please go ahead.

Rich Valera - Needham and Company - Analyst

Larry, first for you. You mentioned in the wireless market visibility remains limited and the demand is relatively weak. Can you just comment on any incremental change quarter-over-quarter? It seems like there has been positive data points particularly out of North America with Lucent getting business and other developments. Anything you see that gives you signs there is some modest improvement here?

Larry Sala - Anaren - Chairman and President and CEO

Well, we've seen contract announcements, but as of yet, we haven't seen a follow-through in demand from recent announcements yet. So, that's something that obviously we're hopeful about and certainly a sign of more strength than we've seen in a while. But, we're still uncertain as to when we'll see a follow-through of actual purchase orders from those recent announcements.

Rich Valera - Needham and Company - Analyst

So, your guidance of \$17m to \$19m, the upper end would imply some wireless growth, is that correct?

Larry Sala - Anaren - Chairman and President and CEO

That's correct.

Rich Valera - Needham and Company - Analyst

Where would you expect -- is that coming more from incremental penetration by you and increased sales of new products or, you know, expected pick-up in demand?



Larry Sala - Anaren - Chairman and President and CEO

It's coming more from recent design wins that we have had that we anticipate will be transitioning into production either late this quarter or in our second quarter. So, we believe it's more timing related to recent wins we have. We are not right now projecting a large up tick in the marketplace as far as this first quarter is concerned.

Rich Valera - Needham and Company - Analyst

Those wins, are those on custom product side?

Larry Sala - Anaren - Chairman and President and CEO

Yes, they are.

Rich Valera - Needham and Company - Analyst

Great. With respect to the wi-fi (ph) components, last quarter you said you could see orders in the hundreds of thousands of units sort of in the near term. Can you update us on sort of expected order levels maybe in September or December for those components?

Larry Sala - Anaren - Chairman and President and CEO

That's the sort of volume we expect to be seeing on a monthly basis between roughly September and year-end. So, we're starting to see pre-production orders of tens of thousands now as the contract manufacturers are starting to move into volume production. We're seeing, as I said, forecasts on the order of 100,000 parts per month moving to 100,000 parts per week as we move into the season of building up for the holiday build-out.

Rich Valera - Needham and Company - Analyst

Great. Joe, with respect to gross margin, backing out the charges and the five-end stuff, looks like you were at 30 and-a-half gross margin in June. Could we expect that to go up in September?

Joe Porcello - Anaren - VP Finance

Yeah, I would expect to see improvement from all the restructuring we did outside of Europe.

Rich Valera - Needham and Company - Analyst

And on the opex side, how do you expect that to trend sequentially?

Joe Porcello - Anaren - VP Finance

I would expect we would come back down again from where we've been. Obviously if you take a look at where the G&A and the marketing and the R&D are running in the fourth quarter they should run somewhat in that neighborhood, but somewhat less.

Rich Valera - Needham and Company - Analyst

Great. If we were doing pro forma number backing out \$900,000 cost of Anaren Europe, what would the tax rate be we should use for next quarter?

Joe Porcello - Anaren - VP Finance

I would say next year's tax rate will be in the neighborhood of about 24%. Really depends on which sub you are in. On average, if you use 24%, should be safe.

Rich Valera - Needham and Company - Analyst

One final question. Larry, could you comment on update on the Celeritek (ph) situation? Looks like they have a more friendly situation there with respect to any type of potential acquisition?

Larry Sala - Anaren - Chairman and President and CEO

Yeah, we have signed a confidentiality agreement with Celeritek in June. We are continuing to pursue and consider the alternatives available to us, as we stated previously in the last 13 D-filings.

Rich Valera - Needham and Company - Analyst

Thank you, guys.

Operator

Our next question comes from Sandy Harrison (ph) of Pacific Growth. Please go ahead.

Sandy Harrison - Pacific Growth - Analyst

Good afternoon, guys. Couple questions. Larry, you talked about your customers in the wireless sector. I guess your top four customers represent about 45% of your overall wireless business. Of the remaining 55%, who are some of those that are some of the up-and-comers and can we expect them to hit in the future any time the 10% level and do you see share shifts or anything going on amongst your customers that would suggest there could be rising stars or so forth?

Larry Sala - Anaren - Chairman and President and CEO

I guess second part first. Obviously with the distribution of our business the last quarter we've seen more strength recently with Motorola than we saw in the first three quarters of the fiscal year. So, they've strengthened somewhat recently. But, we don't have from any customers long enough term forecast to say how long that demand strength will hold up. From our other customers we've seen growth in our business with Nokia. They grew for us just about every quarter this last year. We would expect to see continued growth with Nokia, as well, as we go forward. The only other customer that has been of significance to us has been Nortel. Stronger, again, in the fourth quarter than they were in the previous three quarters. But, we don't have a lot of visibility to say where that demand is going in the future.

Sandy Harrison - Pacific Growth - Analyst

And then any rising stars out of the other 55% that we might look for to crack the 10% level?



Larry Sala - Anaren - Chairman and President and CEO

Beyond Nokia, I don't think we will see a customer expand to more than 10% of revenue. We are seeing pick-up in demand of direct business in Asia. But, I don't see any one customer seeing 10% was our revenue in the near term.

Sandy Harrison - Pacific Growth - Analyst

You were talking about the opportunities on the wi-fi product. Could you remind us sort of you're talking about hundreds of thousands of units a month potentially going to a week. Kind of remind us what is that based upon and what is your average units per or number of products per client perhaps and what maybe ASP we might be able to model out for this?

Larry Sala - Anaren - Chairman and President and CEO

I think we said in the past our existing product line is our balance series product line. We typically see anywhere from two to four design-win opportunities per application per unit. And ASPs can run anywhere from say \$0.10 to \$0.30 depending on complexity of product and functionality, particular balance functionality we are offering. We continue to try to expand the functionality of the products that we offer. We're continuing to prototype with customers and sample products to customers that have functionality beyond just the balance that would increase our dollar content substantially by potentially maybe 50%. So, typically what we've seen in this marketplace is from the time we bring a product to market until we see design-ins and strength is in the six to nine month range. So, the demand that we're expecting between now and Christmas is solely driven by the balance product line we previously announced and have advertised.

Sandy Harrison - Pacific Growth - Analyst

Got you. Just a point on clarification. When you had given the outlook or the guidance range for the first fiscal quarter, did you say that included or excluded the Europe operations?

Larry Sala - Anaren - Chairman and President and CEO

We exclude Europe from the revenue side. Europe is included in our EPS range.

Sandy Harrison - Pacific Growth - Analyst

Okay.

Larry Sala - Anaren - Chairman and President and CEO

So, the \$900,000 loss in Europe is included in earnings guidance range of negative \$0.01 to positive \$0.02. On the revenue side, the \$1m7 to \$19m revenue range excludes any revenue contribution out of Anaren Europe.

Sandy Harrison - Pacific Growth - Analyst

Okay. Thanks.

Operator

As a reminder, if you would like to ask a question or if you have a follow-up question, please press the star key followed by the digit 1 on your touchtone telephone. We will take our next question from JD Abouchar (ph) from Pacific Edge Investment Management. Please go ahead.

JD Abouchar - *Pacific Edge Investment Management - Analyst*

Thanks for taking my call. [Inaudible] balance, is this type of device applicable also to any cellular application on the client side handset?

Larry Sala - *Anaren - Chairman and President and CEO*

Uh, the functionality is applicable to applications like handsets. We believe that the product that we have in the marketplace today is probably physically large for a handset type of application. We're hopeful next generation of that technology will be developed here that are fit the size, as well as the functionality of handset type of application. So, this generation of product, although functionally we think is applicable, we think physically we are a bit large for that application.

JD Abouchar - *Pacific Edge Investment Management - Analyst*

Okay. Next-generation product is six to nine months away?

Larry Sala - *Anaren - Chairman and President and CEO*

Yeah, I would say that is a fair estimate of time. We feel we are one design integration away from being size competitive for handset type of application.

JD Abouchar - *Pacific Edge Investment Management - Analyst*

[Inaudible] similar to the current product?

Larry Sala - *Anaren - Chairman and President and CEO*

Correct probably in that application toward the low end of the ASP that I gave.

JD Abouchar - *Pacific Edge Investment Management - Analyst*

[Inaudible] \$0.10, but a couple [inaudible]?

Larry Sala - *Anaren - Chairman and President and CEO*

Right.

JD Abouchar - *Pacific Edge Investment Management - Analyst*

Just housekeeping. What was depreciation and amortization in the quarter?



Joe Porcello - Anaren - VP Finance

We haven't got that number right here. Call me later and I can give you that.

JD Abouchar - Pacific Edge Investment Management - Analyst

Great. Final question. You talked about design wins with four customers of the 802.11 products. Have you disclosed those customers, if you can't what percentage of the current market do they represent?

Larry Sala - Anaren - Chairman and President and CEO

We don't disclose actual customers in that marketplace. Now, best guess is we're talking about probably two of the four leading players with a large-- more than 50% of the market.

JD Abouchar - Pacific Edge Investment Management - Analyst

Got you. Thanks again.

Operator

We'll take our next question from Kevin Dede (ph) of Marilyn (ph) and Company. Please go ahead.

Kevin Dede - Marilyn and Company - Analyst

Would you mind refreshing my memory on the defense programs you guys are involved with and what you see as the outlook there?

Larry Sala - Anaren - Chairman and President and CEO

Sure. I guess just in general, our main product area on the defense side are radar antenna feed networks. We are largely involved with ground based radar programs such as FAD and variations of that platform. We provide location receivers for airborne applications and we have multiple airframes that technology is used on, Lamps (ph) Helicopter, [inaudible] and several other platforms. We build Jammy (ph) subsystems. Our main business there has been direct business that we do in South Korea as well as the Idecum (ph) program we have been on for many years. We build missile receivers, as well, all of classified nature. Those are the main applications of our defense technology. We've recently announced new work we are doing in military communication satellite applications. Those are the main drivers of our revenue in that space and defense side of the business.

Kevin Dede - Marilyn and Company - Analyst

So, you know, I can see that overall defense spending has gone up. Your stuff seems to be holding fairly constant. Do you see changes in that going forward or what is your general outlook for your niche?

Larry Sala - Anaren - Chairman and President and CEO

If we go back in time back through last fiscal year and prior, the big change in our space and defense business is that during the fourth quarter of fiscal '03, we completed our production work on the Space Way (ph) program. Space Way was our single largest contract. It was a commercial broadband satellite application. Our content in that program was on the order of \$30m. It was a very large percentage of our backlog, two or three

years ago. We really haven't seen any significant demand on the commercial satellite market to replace that business. So, today our backlog is virtually solely defense. We've actually seen growth in our defense business. But, it has not been sufficient to offset that large Space Way program and so you know, we've seen good, consistent demand on the defense side. We're fairly optimistic that we'll see strong book-to-bill ratio again this year. Although we cautioned many times that the timing of defense orders can move significantly so, we're reluctant to really say with too much specificity as to when an actual defense order will occur. The defense business has been strong for us and we expect that to continue.

Kevin Dede - *Marilyn and Company - Analyst*

Okay. Thanks, Larry.

Operator

We'll take our next question from George Iwanyc of CIBC World Markets. Please go ahead.

George Iwanyc - *CIBC world Markets - Analyst*

Could you update what type of cost savings you expect this year and what you think that will bring break-even level down to?

Joe Porcello - *Anaren - VP Finance*

We took out approximately \$5m worth of operating cost over the past year. So, we think the break even range is somewhere in the neighborhood of \$58m to \$60m now.

George Iwanyc - *CIBC world Markets - Analyst*

Okay. And for this coming fiscal year, what type of cost savings do you think you can also generate this year?

Joe Porcello - *Anaren - VP Finance*

Uh, we're still looking to take out some cost. Obviously won't be as significant as it was this year. I would think we would look for probably a \$.5m to \$1m more.

George Iwanyc - *CIBC world Markets - Analyst*

Okay. Can you maybe give us little bit more of an update on Asia, what the transitions are going at your facility there and just the general demand?

Larry Sala - *Anaren - Chairman and President and CEO*

Sure. Our China facility has ramped up the production of our Ferrite (ph) product line, which was our original reason for establishing our presence there, at least our first initiative as far as production goes. We are supporting the majority of our Ferrite assembly out of the China operation now. We are right now in the phase of transitioning some of our custom work into that operation. Initially it will be more of new production work that we have won over the last quarter or two that will be starting up out of our China operation and that we expect to have into production by the early part of October, so, right now the facility is continuing to grow. We're continuing to add staff both on the manufacturing side and the engineering side. By the end of our second quarter we should have a significant amount of custom production work going on there in addition to the Ferrite work that we're doing there now.



George Iwanyc - CIBC world Markets - Analyst

Okay. Thank you very much.

Operator

Once again, if you would like to ask a question or have a follow-up question, please press the star key followed by 1 on your touch-tone telephone at this time. Follow-up question from Rich Valera of Needham and Co., please go ahead.

Rich Valera - Needham and Company - Analyst

Joe, you mentioned you would report Anaren Europe as discontinued op for GAAP. Will you include the loss or exclude the loss when you do that?

Joe Porcello - Anaren - VP Finance

No, on a separate line, Rich. Down below income from continuing operations. It will be net of tax. It will include whatever small level of revenue there is in the quarter and possibly any tax benefits from shutting it down.

Rich Valera - Needham and Company - Analyst

Great. In terms of your sequential expectation for revenue in the Space and Defense business, do you expect that to be down a bit more at the \$6m level going forward from September on?

Joe Porcello - Anaren - VP Finance

I guess right now it is our anticipation that the Space and Defense business will run in the \$6m to \$6.5m quarter range fluctuating quarter-over-quarter.

Rich Valera - Needham and Company - Analyst

Thank you.

Operator

At this time, we have no further questions. I'd like to turn the conference back over to the speakers for any additional or closing remarks.

Larry Sala - Anaren - Chairman and President and CEO

Thank you very much for your time and we look forward to speaking to you again next quarter.

Operator

That does conclude today's conference. We thank you for your participation and you may disconnect at this time.



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