IPG Photonics Corporation

Fourth Quarter 2017 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' fourth quarter 2017 conference call. Today's call is being recorded and webcast. At this time, I would like to turn the call over to James Hillier, IPG's Vice President of Investor Relations, for introductions. Please go ahead sir.

James Hillier:

Thank you operator and good morning everyone. With us today is IPG Photonics' Chairman and CEO, Dr. Valentin Gapontsev, and Senior Vice President and CFO, Tim Mammen.

Statements made during the course of this conference call that discuss management's or the Company's intentions, expectations or predictions of the future are forward-looking statements. These forward-looking statements are subject to known and unknown risks and uncertainties that could cause the Company's actual results to differ materially from those projected in such forward-looking statements.

These risks and uncertainties include those detailed in IPG Photonics' Form 10-K for the year ended December 31, 2016 and other reports on file with the Securities and Exchange Commission. Copies of these filings may be obtained by visiting the Investors section of IPG's website or by contacting the Company directly. You may also find copies on the SEC's website.

Any forward-looking statements made on this call are the Company's expectations or predictions only as of today, February 16, 2018. The Company assumes no obligation to publicly release

any updates or revisions to any such statements. We will post these prepared remarks on our website following the completion of the call. I'll now turn the call over to Valentin.

Valentin Gapontsev:

Good morning everyone.

IPG capped off one of the strongest years in our history with a record fourth quarter and full year 2017. Q4 revenue was above the high end of our guidance. Our fourth quarter book-to-bill ratio was at 1, representing solid performance in light of our record quarterly revenue. We ended 2017 with backlog up more than 40% and current order trends suggest we are off to a rapid start in 2018.

I would like to spend a moment reflecting on our tremendous achievements in 2017. The list of billion-dollar revenue high tech companies that grow annual sales by 40% is very short. And we are pleased to have delivered even stronger growth in operating earnings and free cash flow. Please note that in physical units our growth was even more impressive. For example, in 2017 we produced more than 10,000 lasers with optical power above 1 kW, that is 70% more than 2016. QCW lasers we sold increased by 150%, up to 4,650 units over the prior year. In total, we sold nearly 80% more optical power in 2017 increasing production faster essentially than revenue growth. And it was remarkable absolutely that we fulfilled the orders with no meaningful change in lead time what was very short, about 4 to 6 weeks typically. This achievement reflects excellent planning and manufacturing execution -- for which I thank all of IPG's employees.

Our success in 2017 was largely driven by the secular shift to high-power products. High-power laser sales increased by 50% in 2017, driven by three major growth trends. The first was a shift to ultra-high-power laser sources of 6 kilowatts and above. Sales of ultra-high-power lasers

more than doubled in 2017, representing more than 30% of our high-power revenue. The world-leading power, compactness, electrical efficiency, and reliability of IPG fiber lasers is driving substantial productivity gains within the cutting, welding and sintering markets. Secondly, we experienced rapid growth in laser sources of 1 to 2 kilowatts for lower-end cutting systems, which are now displacing non-laser machine tools such as punches and presses. We believe unit volumes of these lower-end cutting systems have doubled over the last 2-3 years as they provide machine shops with greater flexibility, productivity, and return on investment. The third major growth driver was in welding applications. We believe electric vehicle battery production drove a rapid expansion of the laser-based welding market in 2017 as our high-power CW and pulsed lasers are used within a variety of battery production applications. In addition, the transition to high-strength, lighter-weight vehicle materials to improve fuel economy provides additional opportunities for laser-based welding to take share from non-laser technologies like resistance spot welding, arc, MIG, and TIG welding, adhesives, and riveting. Finally, QCW laser sales for welding in consumer electronics also grew dramatically during the year.

Within newer product categories, sales of high-power, 100 watt and above, nanosecond pulsed fiber lasers increased more than 80% in 2017 driven by a diverse set of applications that include foil cutting and terminal cleaning for batteries, solar cell scribing and drilling, laser trimming for displays, and oxide removal from metals prior to welding. Green pulsed lasers used to improve solar cell efficiency also grew strongly during the year. We delivered rapid growth in sales of beam delivery products and fully integrated systems to drive new applications for laser technology. Our systems business reached $40 million in annual sales driven by macrosystems, which include the ILT business we acquired last year, our seam stepper and our integrated

marker and many other applications. We continue to develop successful new laser technologies and macro systems for automobile, oil, gas, aerospace and other mass applications. For example, at the end of last year we installed in one large production fab our first high volume side panel welding machine for high speed passenger railway cars.

We also sold our first commercial cinema projection systems in 2017. Finally, we delivered double digit growth in beam delivery products, a business that today totals more than $60 million in annual sales. This growth is being fueled by our expanding portfolio of cutting, welding and scanning heads that are uniquely suited for high-power laser applications. Our December acquisition of LDD further compliments our beam delivery product lineup. There has been a very favorable response to this acquisition as it enhances our real-time weld monitoring capability and competitive position.

We continue to see encouraging customer interest in our newest products. We have received initial orders for our family of ultrafast pulsed lasers that expand our addressable market opportunity in the micro materials processing, marking and engraving, medical, and scientific markets. Our fast-expanding family of picosecond and femtosecond pulsed fiber lasers overcome the limitations of traditional ultrafast products that are high-priced, bulky, and inconsistent in performance. IPG's ultrafast products offer a fiber-coupled design with easy systems integration, much higher wall-plug efficiency, a compact footprint, more consistent energy per pulse, a faster cold-start time, and a significantly lower investment and cost of ownership. These products were on display at the recent Photonics West tradeshow, receiving strong interest from customers and prospects. Combining ultrafast opportunities with continued

progress in UV and visible lasers, medical and dental lasers, unique super high lumen RGB systems, the defense industry, instrumentation, and scientific applications, IPG is unlocking multiple potential growth drivers for the next three to five years that together more than double our addressable market.

We are very pleased to have delivered our strongest annual growth in six years, a direct result of our scale advantages and our unique business model combining a vertically-integrated manufacturing operation with broad-based technology and process abilities. This business model enables us to rapidly increase production, reduce costs, and deliver innovation. Looking ahead, we see excellent opportunities to leverage these advantages within both our core markets and new applications. making our fiber laser technology the tool of choice in mass production.

With that, I'll turn the call over to Tim.

Tim Mammen:

Thank you Valentin and good morning everyone. I will review the key financial highlights of the fourth quarter. For additional details on our reported results, including full-year results, please refer to the Excel-based financial data workbook posted to our investor relations website.

Revenue in the fourth quarter grew 29% to $361 million, exceeding our guidance of $330 million to $355 million. Our outperformance during the quarter and throughout the year was across multiple regions, applications, and products. Q4 revenue in China increased 47% year over year, representing 44% of total sales, driven by high-power CW lasers for cutting applications. Sales in Europe increased 18% year over year with strength in medium-power lasers for 3D printing applications, which more than doubled versus the year ago period. Additive manufacturing processes such as laser sintering are now our fourth largest application area, reaching total sales of $50 million in 2017. US fourth quarter revenue increased 16% year over year, as strength in systems, high-power lasers, and our government business offset softness in communications. Fourth quarter sales in Japan increased 2% year over year despite a challenging comparison versus the year-ago period as growth in welding & brazing and marking & engraving applications offset ongoing softness at our largest customer in the region. As noted last quarter, we have seen a meaningful sales increase this year among Japan-based OEMs within other regions, including Europe, North America and China. As a result, we estimate sales to Japan-based OEMs in all regions increased by a double-digit percentage in the quarter and were flat for the full year 2017.

Turning to performance by product, high-power laser sales increased 40% year over year in Q4, 50% in 2017 and contributed more than 70% of the incremental revenue we generated in 2017. Pulsed lasers sales grew 20% year over year in Q4 and 15% in 2017 with solid contributions from low-power pulsed lasers for marking and engraving applications and green and high-power pulsed lasers for drilling, cleaning, trimming, and solar-related applications. QCW sales increased 13% year over year and more than 80% for the full year from strength in fine welding for consumer electronics applications drilling for aerospace. Medium-power laser sales increased 5% driven by a substantial increase in demand from 3D printing customers and growth in fine welding which offset the decline in medium power cutting that is attributable to the shift by OEMs to high-power lasers. Finally, sales of other products increased 26% year over year in Q4 and 34% in 2017 due to strong sales growth in systems and beam delivery products that Valentin referenced.

Gross margin of 57.8% was up 230 basis points from Q4 2016. We were able to more than offset declines in average selling prices compared with a year ago with improved manufacturing efficiency, cost reductions, and favorable product mix. Q4 operating income was $148 million, or 41% of sales, well above Q4 2016. We were able to achieve positive leverage in sales and marketing, R&D, and G&A while continuing to invest in product development and the expansion of our global sales force and administrative footprint.

Q4 net income was $53 million and earnings per diluted share were $0.96, as charges related to the 2017 U.S. Tax Cuts and Jobs Act reduced net income by $49 million and EPS by $0.90. These charges were partially offset by a $4 million benefit from stock options exercised and

RSUs released during the quarter. We ended Q4 with cash, cash equivalents, and short-term investments of $1.12 billion and total debt outstanding of $49 million. Cash provided by operations was $108 million and capital expenditures were $27 million in Q4. During the fourth quarter we repurchased 60 thousand shares for $13 million as part of our antidilutive repurchase program and have now repurchased 378 thousand shares for $49 million since the program began in July 2016.

Our year-end backlog increased 80% to $744 million. Orders with firm shipment dates increased 44% to $326 million, and we believe this gives us good visibility over the next 3-4 months. Frame agreements, which are non-binding indications of customer pricing and volume levels, increased more than 100% to $417 million. The growth in frame agreements reflects strong underlying demand, as well as timing issues at year-end 2016, when approximately $100 million of frame agreements were received in early 2017. Adjusting for this timing issue last year, the increase in frame agreements and total backlog would be similar to the 44% increase in orders with firm shipment dates.

Turning to guidance, for the full year 2018 we are targeting 10% to 15% revenue growth. Our annual guidance reflects current backlog and annual order indications from our largest OEM customers. This guidance assumes continued momentum in our core materials processing markets, further progress in new application areas, and strong worldwide macroeconomic conditions offset by lower spending related to consumer electronics applications. Based on the accelerating growth within our business in 2017, we expect capital expenditures to be $170 million to $190 million, the high end of our target range of 8% to 12% of revenue. Finally, we

expect the recently enacted U.S. tax legislation to lower our corporate tax rate in 2018 to 26% from 30% in 2017, excluding effects relating to equity grants. As we continue to assess the benefits of tax reform to IPG, we believe that we may be able to reduce our effective rate a little further.

For the first quarter, we expect revenue growth in the range of 15% to 24% year over year or $330 million to $355 million and anticipate earnings per diluted share in the range of $1.62 to $1.87, which reflects earnings growth in the range of 17% to 36% year over year. As discussed in the "Safe Harbor" passage of today's earnings press release, actual results may differ from our guidance due to factors including, but not limited to, product demand, order cancellations and delays, competition and general economic conditions. Our guidance is based upon current market conditions and expectations, assumes exchanged rates referenced in our earnings press release, and is subject to risks outlined in the Company's reports with the SEC.

With that, Valentin and I will be happy to take your questions.