IPG Photonics Corporation

First Quarter 2018 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' first quarter 2018 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 Melissa 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 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 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, 2017 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, May 1, 2018. The Company assumes no obligation to publicly release any updates or revisions to any such statements. For additional details on our reported results,

please refer to the earnings press release and the Excel-based financial data workbook posted to our investor relations website. We will post these prepared remarks on our investor relations website following the completion of the call. With that, I'll now turn the call over to Valentin.

Valentin Gapontsev:

Good morning everyone.

The momentum that carried IPG through an outstanding year in 2017 continued in the first quarter of 2018. We delivered record first quarter revenue and EPS. In addition, we achieved the highest level of quarterly bookings in the company's history during the first quarter. As a result, our Q1 book-to-bill ratio was above 1, positioning us to deliver strong results in the second quarter. We continue to ramp production, meeting the demands of our customers by shipping record volumes of high power and ultra-high power fiber lasers . And it is very important that despite the tremendous increase in volume, our customers have experienced no change in product lead times. Our unique technologies and vertically-integrated business model enable us to more rapidly scale production, reduce costs, and deliver innovation faster than the competition. As a reminder, there is no company that can deliver high power laser solutions at our scale, quality, cost and lead time.

The rapid adoption of IPG's high power products across our largest applications and geographies continues to drive outperformance. Our high power fiber lasers enable faster processing speeds, along with superior productivity and flexibility. During the first quarter, sales of high power CW lasers increased 37% year over year with even higher growth in units. Sales of ultra-high power solutions at six kilowatts and above increased more than 60% year over year and are approaching 40% of total high power product sales. Our largest OEM customers are migrating to higher power fiber laser cutting solutions at 10 kilowatts, where IPG has a unique

solution in the marketplace. A handful are also testing our fiber lasers at 12 and 15 kilowatts, which continue to demonstrate faster cutting speeds and improved productivity for the end user.

At the lower end of the cutting systems market, we continue to see customers purchase our 1 kilowatt and 1.5 kilowatt rack-mounted fiber lasers in record numbers. With the recent introduction of IPG's new 2 kilowatt rack-mounted product, we expect the strong growth in this market will continue. The market for lower end cutting systems in China continues to expand rapidly, driven by the superior productivity and flexibility of fiber laser cutting systems over non-laser technologies such as punch presses that use inflexible dies that take weeks to build and wear out over time.

We are benefiting from rapid growth within new product categories as well. Pulsed laser sales increased 18%, driven by our 100 watt and above, fiber lasers, which increased more than 25% year over year. Market acceptance of these products is occurring across a diverse set of applications including foil cutting and terminal cleaning for batteries, solar cell scribing and drilling, and laser trimming for displays. Sales of green lasers used as an ablation tool for improving solar cell efficiency doubled versus the year-ago period.

Among our newest products, we saw our first consistent revenue from ultraviolet lasers used for marking and engraving of non-metals and material ablation. And we continue to see encouraging customer interest and order activity for our new ultrafast picosecond and femtosecond laser families. This early interest is across a variety of customers in the US and Europe for many different applications within micro materials processing. Initial feedback has been very encouraging, with customers praising the consistent energy per pulse, fast cold start

time, compactness, and electrical efficiency of our products over incumbent solutions. These new products are driving our addressable market expansion with the micro materials processing, scientific, and medical arenas.

We are also expanding into new markets by selling more optical accessories and fully integrated systems to drive new applications for laser technology. Sales of beam delivery accessories, including high power welding and cutting heads, scanners, collimators, beam switches, process fibers, smart power supplies and chillers, grew at a faster rate than total sales this quarter, as we continue to see strong customer interest in these products. The acquisition of LDD and the addition of real-time weld monitoring capabilities is also helping us sell more integrated beam delivery solutions and provides a competitive advantage for our lasers within new laser-based welding opportunities. Our systems business was also a strong contributor in the quarter, as we continue to target opportunities in the automotive, aerospace, railway, pipeline, and medical device industries.

Finally, many of you probably saw that IPG Photonics was recently added to the S&P 500 index. It is an honor to be included in this large cap equity index along with other leading U.S. public companies. We view this as a milestone for our company, reflecting the successful execution of our strategy and our industry-leading financial performance since our initial public offering in 2006. However, we believe IPG's future is even brighter. We continue to accelerate adoption of high power fiber laser technology within our core markets enabled by the superior productivity, reliability, and cost of ownership of our products over the competition. In addition, we continue to expand our addressable market with the introduction of new products. These include our unique

super high lumen RGB systems, super high power amplifiers and fiber lasers and high power diodes for the defense industry, and our UV, ultrafast, and visible light lasers that enhance our presence in non-metal materials processing, medical, and scientific applications. With some of these, ultraviolet for instance, we received multiple hundred unit order. With these solutions, IPG is unlocking multiple potential growth drivers for the foreseeable future, as we execute on our mission to make 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 quarter. Revenue in the first quarter grew 26% to $360 million, exceeding our guidance of $330 million to $355 million. Revenue from materials processing applications increased 28% year over year, driven by rapid growth in lasers sold for cutting and 3D printing applications. Revenue from other applications decreased 5% year over year.

By region, first quarter revenue in China increased 29% year over year and represented approximately 42% of total revenue. Sales of high power CW lasers for cutting applications drove the vast majority of the revenue increase in China versus the year-ago period. Welding sales in the region were up sequentially, but declined on a year over year basis due to the expected reduction in demand related to the smartphone investment cycle. In addition, we saw a slight pause in activity related to electric vehicle battery welding in the region, which like our other automotive business, tends to be project driven. However, based on current order trends, we continue to expect a strong 2018 for EV battery welding applications.

In Europe, growth accelerated to 35% year over year, driven by strength in high power lasers for cutting and welding applications, medium power lasers for 3D printing applications, and pulsed laser sales for marking, engraving, and solar cell manufacturing. In the US, first quarter revenue increased 3% year over year, as strength in cutting and welding applications offset lower sales in telecommunications. Sales in Japan increased 39% year over year driven by a rebound in cutting, welding, and marking and engraving business after a softer 2017. Although Japan has

lagged other regions in its adoption of fiber laser technology, we continue to target compelling expansion opportunities in cutting, welding and other applications areas within the region. Recently we hired a new president of IPG Japan, and continue to make investments in new sales personnel and facilities to augment and enhance our capabilities in the region.

Turning to performance by product, high power laser sales increased 37% year over year to $231 million in the first quarter and represented more than 64% of total revenue. As Valentin noted, fiber lasers at 6 kilowatts and above grew at an even faster pace and now account for nearly 40% of all high power laser sales. Pulsed lasers sales grew 18% year over year. We experienced rapid growth in sales of our newer green and high power pulsed lasers across a diverse set of applications, and these products represent nearly half of our pulsed laser sales. Sales of low power pulsed lasers for marking and engraving applications also grew strongly during the quarter. Medium power laser sales increased 9% driven by demand from 3D printing customers, which offset the decline in medium power cutting attributable to the shift by OEMs to kilowatt-scale lasers that Valentin discussed. Other product sales increased 21% year over year due to strong sales growth in systems and beam delivery accessories.

QCW sales of $16 million declined 24% year over year due to the expected reduction in demand related to the smartphone investment cycle. As a reminder, we benefit from the purchase of QCW lasers used in the production of new smartphone models, with these major smartphone redesigns occurring every other year. Because we saw a significant QCW benefit from the smartphone industry last year, we did not expect this to occur again in 2018, and this was factored into our 2018 guidance. However, with the increasing complexity of each new

smartphone model, laser technology continues to capture share from non-laser processing. Furthermore, IPG's expanded product portfolio of high power pulsed, UV, and ultrafast products enhances our ability to capture market share in future smartphone investment cycles.

First quarter gross margin of 56.5% was up 150 basis points from Q1 2017 and above our guidance range of 50% to 55%. We were able to more than offset declines in average selling prices with improved manufacturing efficiency, cost reductions, and favorable product mix. First quarter operating income was $141 million, or 39.2% of sales, well above Q1 2017. Excluding a foreign exchange gain of $5 million, operating margin was 37.7%. Operating expenses as a percentage of sales increased 80 basis points year over year. Relative to Q4, accruals for bonuses in Q1 were higher due to the phasing of revenue in 2017. In addition, employer taxes and benefits accelerated into Q1 due to bonus payments and realized equity compensation. Finally, we are making necessary investments in administrative talent and IT systems to help ensure the company can continue to grow at a rapid rate. Looking ahead, we expect operating expenses to decrease as a percentage of revenue in Q2.

Q1 net income was $106 million and earnings per diluted share were $1.93, above our guidance of $1.62 to $1.87. Foreign exchange gains benefited EPS by $0.07. The effective tax rate in the quarter was 25%. Excess tax benefits on equity compensation, partially offset by increases in reserves for uncertain tax positions and other discrete items benefited EPS by $0.06. However, this tax benefit was offset by the impact of Global Intangible Low Taxed Income (GILTI) arising from the U.S. Tax Cuts and Jobs Act. While the Act reduced the headline Federal tax rate to 21%, included in the legislation was a special deduction for Foreign Derived Intangible Income

(FDII) and additional tax for GILTI. For IPG, the GILTI tax exceeded the FDII deduction benefit. Even though GILTI claims to levy a special tax on low-taxed income and IPG's effective tax rate on foreign income is approximately 29%, which is above the new U.S. tax rate, the rules related to foreign tax credit limitations and allocation of domestic expenses to foreign income mean that IPG, like many other companies, has had to accrue additional taxes in the first quarter related to GILTI. The impact of GILTI net of our FDII benefit reduced EPS by $0.06. Therefore, the net benefit to EPS from these tax items and from foreign exchange was $0.07.

We ended the quarter with cash, cash equivalents, and short-term investments of $1.18 billion and total debt of $48 million. Our current level on inventory amounts to 205 days, above our target range of 2 turns or approximately 180 days. This inventory build is ahead of what we anticipate will be a significant increase in shipments during Q2. We have increased diode inventory, which had been running as low as 3 to 4 months last year, to approximately 6 months. The inventory investment during Q1 has enabled a strong start to product shipments in Q2.

Cash provided by operations during the quarter was $100 million, up 96% from Q1 2017. Capital expenditures were $39 million, up 79% year over year. We repurchased 83 thousand shares for $20 million as part of our antidilutive repurchase program and have now repurchased 461 thousand total shares for $69 million since the program began in July 2016.

Turning to guidance for the second quarter 2018, we expect revenue of $400 million to $430 million, representing growth of 8% to 15% year over year. We expect our second quarter tax rate to be approximately 26% excluding effects relating to equity grants, and anticipate delivering earnings per diluted share in the range of $2.05 to $2.35, representing growth in the range of

7% to 23% year over year. At this time, we are not updating our 2018 annual guidance. 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.