IPG Photonics Corporation

Third Quarter 2018 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' third 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 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 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, October 30, 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.

Q3 was a challenging quarter as macroeconomic and geopolitical factors reduced demand for our laser products. Despite these challenges, IPG made important progress driving higher power solutions into the market and generating meaningful traction selling our newest products and solutions. We believe our progress in high power and new products will help us emerge from the current downturn in a stronger competitive position with greater opportunities to address the growing market for laser solutions.

As noted in our preliminary earnings release, we believe tariff and trade-related headwinds were the primary driver of weaker than expected performance for our business in China and Europe where China is the main market for metal processing machines. Indications from our customers suggest that purchases of laser systems in these regions are being pushed out. We believe uncertainty resulting from the ongoing US-China trade conflict is reducing overall demand for industrial capital equipment purchases, predominantly in China. In addition, we believe the softening macroeconomic climate in China and Europe, as indicated by lower manufacturing PMI and reduced levels of infrastructure investment, is affecting near-term demand for laser systems.

However, we remain confident in the longer-term secular growth of fiber laser technology over other lasers and non-laser tools. During prior business downturns, we have seen customers begin to increase investment in transformational automation and miniaturization technologies that include our laser solutions in order to improve productivity and launch new products. We

continue to expect our solutions to gain share from traditional tools and process technologies due to the superior productivity, flexibility, precision and power of fiber laser systems.

We remain the clear market leader in fiber laser technology. That said, competition in continuous wave laser products at less than four kilowatts has increased. Some competitors have also announced continuous wave lasers with power output of up to 10 kilowatts. China remains our largest and most competitive market. As we have previously indicated, we are seeing aggressive pricing for select products by our competitors in China. However, we believe our advanced technology, scale and cost advantage over the competition are enabling us to win in the market despite these pricing actions.

As our response to the new market situation, during the third quarter we introduced new ultra compact 1 to 3 kilowatt lasers and other products designed specifically for the market in China. With the benefit of additional production capacity and these new solutions, we were able to sell several hundred more higher power lasers to OEMs in China that were either exclusively or predominantly buying lasers from our competition. We have won new business in part because some of these customers have expressed fast-growing concern and frustration with the performance and reliability of competitor products. The revenue impact from these gains has been limited by macroeconomic and geopolitical headwinds, but these early efforts are yielding positive results. As a reminder, we believe there is no company that can deliver high power laser solutions at our quality, scale, cost and lead time.

We continue to drive market acceptance of our ultra high power fiber laser technology at six kilowatts and above, which is now approaching 50% of our high power laser sales. We continue to see our largest OEM customers migrating to higher power fiber laser cutting solutions, and Q3 was a record quarter for sales of our unique 12 and 15 kilowatt lasers. We also introduced the world's smallest 20 kilowatt cutting laser, further demonstrating IPG's industry leadership in

producing the highest power solutions in the marketplace. These ultra high power lasers are experiencing rapid adoption as they enable faster cutting speeds and improved end user productivity.

Augmenting our super high power lasers portfolio, we are introducing three new products that will be featured at the upcoming FABTECH tradeshow in Atlanta. First, we are introducing a new QCW mode for our YLS and YLR CW lasers that provides peak power up to two times average power, allowing increases in piercing speed, quality and improved piercing of thick metals. The reduced heat input in the QCW mode results in higher quality cuts of intricate parts and cleaner, more controlled drilling of thicker materials. This unique capability is enabled by IPG's new QCW diode designs that provide very high peak power for short duty cycles. Second we are launching Adjustable Mode Fiber capability on our flagship YLS lasers, which allows programmable adjustment of output beam mode and enables our customers to process a wider range of material thicknesses and improve piercing and cutting quality, as well as optimize welding performance in certain material combinations. Third, we are introducing an integrated high power scan head with our recently acquired weld monitoring technology to meet the ever increasing quality monitoring requirements for industries such as automotive and medical. These three new innovations are all examples of how IPG is committed to decreasing our customer's cost of ownership and increasing their overall productivity.

We also made solid progress in our newest product areas, which are outside metal processing. We believe these products are driving less dependence on sales into the Far East, including China. Sales of green pulsed lasers used as an ablation tool for improving solar cell efficiency increased nearly 70% versus the year-ago period. We achieved a record quarter for our new ultraviolet laser solutions, which are expanding our addressable market for marking and engraving of non-metals and for material ablation. Our new unique family of picosecond and femtosecond ultrafast pulsed lasers increased sales meaningfully off a small base and are

seeing good customer acceptance for micro processing applications. Sales of systems and beam delivery products increased more than 20% year over year, evidence we are becoming a more complete solutions provider within the automotive, aerospace, railway, pipeline, entertainment and medical device and telecom industries. Collectively, sales of these new products increased approximately 10% year over year and now represent more than 10% of total revenue. Over the coming years, these new applications areas are targeted to grow to 50% of total revenue, diversifying our end market exposure with less dependence on any one application area.

We remain optimistic about IPG's growth prospects over the medium- to longer-term given our technology and cost advantages combined with the significant market opportunity for lasers to take share from traditional processing technologies. We believe growth in our core industrial markets is enabled by the superior performance, productivity, reliability, and cost of ownership of our products over competing solutions. We expect to augment this growth with advances in new product areas that meaningfully expand our addressable market in the micro materials processing, medical, defense, scientific, projection and display industries. This includes providing more complete systems and solutions to end customers in the aerospace, oil and gas, electric vehicle, and medical device industries as we drive penetration of advanced laser processing. Despite the challenging macroeconomic and geopolitical backdrop, I remain confident in IPG's multiple growth drivers for the long-term, as we deliver 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. Revenue in the third quarter declined 9% to $356 million. Foreign exchange headwinds during the quarter relative to sales assumed in our Q3 guidance reduced revenue by $5 million. Without this impact, revenue would have been slightly above the low end of our guidance range. Revenue from materials processing applications decreased 11% year over year and revenue from other applications increased 22%.

By region, third quarter revenue in China decreased 9% year over year and represented approximately 45% of the total. Modest year over year growth in sales of high power CW lasers for cutting applications was more than offset by declining sales of lasers into welding applications. In macro welding, we saw reduced demand from traditional automotive and electric vehicle battery welding applications on a year over year basis. However, during the third quarter we received the largest order for battery processing applications in the company's history. As such, we believe this business should begin to strengthen in Q4. In micro welding we continue to see reduced demand related to the consumer electronics investment cycle. Past investment cycles for consumer electronics have materialized every other year, which would suggest that we should see better performance in 2019.

In Europe, revenue decreased 25% year over year primarily due to softness in cutting, additive manufacturing and welding. As Valentin noted, we believe a weaker macroeconomic climate in the region is the primary driver of reduced demand for lasers serving the cutting market. In addition, we faced a challenging comparison versus the year-ago period when we achieved record sales within cutting applications and record shipments of ultra high power lasers. As we noted last quarter, we continue to expect lower sales into European additive manufacturing due to excess inventory at one of our larger customers. In North America, revenue increased 29%

year over year driven by strength in cutting, welding and government applications. Sales in Japan increased 4% year over year with a continued rebound in cutting offset by declines in welding and marking and engraving. Sales in Korea were consistent with the prior year, and revenue in Turkey decreased 29% year over year, which is not surprising given the recent economic turmoil in that country.

Turning to performance by product, high power laser sales decreased 7% year over year to $227 million in the quarter and represented more than 64% of total revenue. Reduced sales of lasers for welding, cutting and additive manufacturing were partially offset by strength in sales to government applications. Sales of fiber lasers at 6 kilowatts and above increased more than 10% year over year and now account for nearly 50% of all high power laser sales, driven by strong adoption in cutting applications. Sales of other high power lasers declined year over year due to the weaker demand environment in China and Europe that Valentin cited.

We are seeing aggressive pricing for select products by our competitors in China, most notably 1-3 kilowatt lasers serving the cutting market. Pricing pressures in this business are being exacerbated by softening demand trends. However, with the benefit of additional production capacity and new ultra compact high power laser solutions, we are more aggressively targeting OEM accounts in China that were either exclusively or predominately buying lasers from competition. Early progress in these efforts has helped to offset some of the pricing and demand-driven pressure in our high power cutting business and contributed more than $10 million in additional revenue during the quarter.

Pulsed lasers sales decreased 11% year over year, with rapid growth in green, ultraviolet and ultrafast pulsed lasers offset by reduced sales of other pulsed products. Medium power laser sales decreased 48% on softness in additive manufacturing and cutting. QCW sales of $18 million declined 23% year over year due to the expected reduction in demand related to the

consumer electronics investment cycle, partially offset by strong growth in higher power QCW sales into welding and aerospace drilling applications. Other product sales increased 10% year over year due to strong sales growth in systems and beam delivery accessories.

Gross margin of 54.8% declined 242 basis points from Q3 2017 and was at the high end of our guidance range of 50% to 55%. The decline in gross margin was largely attributable to the lower revenue in the third quarter of 2018 versus the year ago period and as a result less favorable absorption of manufacturing costs. However, we were able to partially offset this impact with continued cost reductions and favorable product mix. Third quarter operating income was 124 million, or 34.8% of sales, down 605 basis points from Q3 2017. Excluding a foreign exchange loss of 2 million, operating margin was 35.2%. Operating expenses as a percentage of sales increased 410 basis points year over year as we continue to make necessary investments in sales, engineering and administrative talent, as well as in IT systems. On a sequential basis, operating expenses increased 250 basis points as a percentage of sales.

Net income was 101 million and earnings per diluted share were $1.84. Foreign exchange losses reduced EPS by $0.03. If exchange rates relative to the US Dollar had been the same as one year ago, we would have expected revenue to be $8 million higher and gross profit to be $4 million higher. The effective tax rate in the quarter was 21%, which included certain discrete tax items that benefited EPS by approximately $0.14. Included in these items, we now expect a net benefit from the Global Intangible Low Taxed Income (GILTI) provisions and Foreign Derived Intangible Income (FDII) deductions in the US Tax Act due to clarification from the IRS on how these taxes should be calculated. Excluding discrete items the effective tax rate was 27.5%.

We ended the quarter with cash, cash equivalents, and short-term investments of $1.12 billion and total debt of $46 million. During the quarter we repatriated $116 million in cash from Europe

into the US. Having now repatriated $522 million from Europe, US cash and investments now represent 78% of total.

Cash provided by operations was $72 million during the quarter and was $280 million a year-to-date basis. Capital expenditures were $37 million during quarter and were $133 million on a year-to-date basis, up 34% year over year. We continue to invest in new facilities and equipment to meet demand for our products over the next several years. In Q3 we repurchased 371 thousand shares for $61 million representing nearly half of the new $125 million repurchase authorization we announced in August.

Turning to guidance, global macroeconomic and geopolitical headwinds have persisted into the fourth quarter affecting our business along with others in the sector. As a result, order flow has continued to soften. We are seeing aggressive pricing for select products by our competitors in China, and we expect currency headwinds to be greater in the fourth quarter than in the third quarter. However, we have made strides competitively selling several hundred more high power lasers during the third quarter to manufacturers of laser cutting systems in China that were either exclusively or predominantly buying lasers from our competition. We are encouraged by this progress and the strength in new products and the performance of other regions.

Based on these factors, for the fourth quarter 2018 we expect revenue of $300 million to $330 million. We expect our third quarter tax rate to be approximately 26% excluding effects relating to equity grants. We anticipate delivering earnings per diluted share in the range of $1.30 to $1.50. Based on this guidance, we now expect full year revenue growth for 2018 will be in the range of 1% to 4%, down from our prior outlook of 7% to 9%.

We believe there are some encouraging signs for 2019. Indications from several customers in China suggest that order flow may improve in the first quarter. We expect spending on consumer electronics, electric vehicle battery and other metal welding projects to increase in 2019 over

2018. In addition, we believe our early traction in new product areas will drive increasing contributions next year from micro materials processing applications, telecom, entertainment and display products and our systems business. However, our visibility of a trough in the current downcycle is limited by the uncertainty surrounding the global macroeconomic trade and geopolitical environments.

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, tariffs, trade policies and general economic conditions. Our guidance is based upon current market conditions and expectations, assumes exchange 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.

Valentin Gapontsev:

Thank you for joining us this morning. We look forward to speaking with you on next quarter's call. Have a great day.