IPG Photonics Corporation
Second Quarter 2019 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' second quarter 2019 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, 2018 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, July 30, 2019. 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:

Our second quarter results were strong. Driven by improving trends in our China business during April and May, we sold a record number of high power lasers during the quarter. Although the macroeconomic climate and the pricing environment both remain challenging, we delivered results in the upper half of our guidance range, while demonstrating solid traction in new products. We continue to meet competitive challenges by substantially reducing component and manufacturing costs while introducing new products that improve productivity and increase flexibility for our customers. As widely reported, the macro economy has softened and the geopolitical climate has become more unstable over the last few months. As a result we again find ourselves in a more uncertain position with limited near-term visibility to improving business conditions. Despite the volatile geopolitical and business environment, we will continue to invest in new products and applications to substantially enhance our competitive position.

IPG remains the clear market leader in fiber lasers with hundreds of megawatts of installed capacity. During the second quarter, our megawatts of total optical power shipped reached a record level. We were able to successfully meet the strong sequential growth in demand for our laser products coming from China, with record shipments into the region. We continue to see aggressive pricing among China-based competition, which intensified toward the end of the second quarter. Nevertheless, we achieved strong sequential growth in high power laser sales.

We have many laser products and systems that are unique in the industry. Chief among these, we continue to produce high power CW lasers for cutting, welding and other materials processing applications at industry leading power levels, beam stability and wall plug efficiency. Sales of ultra high power fiber lasers at 6 kilowatts or greater accounted for nearly 50% of all high power laser sales. Sales of lasers at 10 kilowatts or greater grew 16% year over year, driven by rapid adoption in cutting applications.

We have started shipping our new high peak power lasers, receiving encouraging feedback from our customers. These new products offer a differentiated solution to cutting OEMs, providing us with a distinct advantage in a competitive market. This unique capability increases piercing speed, improves cut quality, delivers cleaner, more controlled drilling of thicker materials and reduces scrap by enabling closer nesting of parts.

We are seeing compelling customer interest in our new generation of lasers with adjustable mode beam capability that permits reliable adjustment of the output beam. AMB is shown to reduce spatter, increase speed and improve quality in welding applications, and our AMB products are being evaluated by leading edge battery producers. In the cutting market, OEMs can cut a wide range of material thicknesses using our AMB lasers or our standard high power lasers with our unique family of high power optical heads.

We delivered excellent progress in new product areas outside metal processing. Sales of green pulsed lasers used to improve solar cell efficiency increased 150% year over year and nearly doubled on a sequential basis. We increased sales of our ultrafast pulsed lasers more than 200% year over year and nearly 50% sequentially. We are actively working on more than 50 new projects for these lasers across a wide range of applications processing glass, ceramics, circuit boards, OLED film, batteries and solar cells. Sales of our newest pulsed lasers, which include those at visible and ultraviolet wavelengths and ultrafast pulse durations, now exceed $10 million per quarter and are growing more than 60% year over year. As we expand our portfolio of new pulsed lasers and capitalize on the many application opportunities for our differentiated fiber laser solutions, we expect revenue for these products to grow rapidly over the coming years.

Systems sales increased more than 50% year over year, excluding Genesis, driven by strong growth in macro systems for welding and other materials processing applications. In addition, our seam stepper had a record quarter with sales into several large automotive customers.

Sales of beam delivery accessories increased 10% year over year. Toward the end of the quarter, we received a large order for our medical laser solution addressing a surgical application, enhancing our visibility into strong growth in medical this year. Collectively, second quarter sales of newer laser products and systems into emerging applications grew 12% year over year in the second quarter and were 17% of total revenue.

I am pleased to report that we continue to demonstrate meaningful traction in ultra high power fiber lasers while investing in new products and applications that expand our addressable market opportunity. While macro factors are creating near-term headwinds in our business, our continued focus on developing and enhancing our differentiated laser solutions will drive the company's growth for many years. As a reminder, our mission is to make IPG's fiber laser technology the tool of choice in mass production, and I remain confident in our ability deliver on this mission.

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

Tim Mammen:

Thank you Valentin and good morning everyone.

Revenue in the second quarter declined 12% year over year to $364 million. Revenue from materials processing applications decreased 12% year over year and revenue from other applications decreased 16%.

Examining performance by region, second quarter revenue in China decreased 19% year over year versus a record quarter a year ago, and represented approximately 45% of the total. On a sequential basis sales in China increased more than 40% driven by cutting, welding and marking applications. Following the escalation of the US-China trade conflict, we have seen a slowdown in order volume during the month of June that has continued through the first three weeks of July. Unfortunately, we believe this is now likely to delay the recovery that had been underway in China. The pricing environment in China remains intense, affecting the dollar value of units sold. Our team is focused on further cost reductions throughout the manufacturing process. These cost reductions will only partially offset more aggressive pricing actions by the competition, and weaker unit volumes arising from the challenging macroeconomic backdrop will be a headwind to growth during the third quarter.

In Europe, revenue decreased 22% year over year primarily due to softness in cutting and additive manufacturing, partially offset by growth in welding. While pricing pressure in Europe has not been as intense as in China, the decrease in average selling prices in Europe has been above our historic average of late, affecting revenue during the quarter. Within the region, we have seen a slowdown in Italy, a market which had held up better during the course of 2018. Looking ahead, we believe the persistent macroeconomic weakness throughout Europe is likely to pressure results in the region.

In North America, revenue increased 34% year over year driven by the acquisition of Genesis. Excluding Genesis, sales in North America decreased 5% year over year with strong growth in welding and cutting offset by declines in marking, telecom and government applications due to project timing and more challenging comparisons. Sales in Japan decreased 10% year over year on softness in marking, welding and cutting. Sales in Korea decreased 14% year over year, though strong bookings suggest improved Q3 performance, and revenue in Turkey decreased 31% year over year given macroeconomic pressures in the region.

Turning to performance by product, sales of high power CW lasers decreased 20% year over year and represented approximately 59% of total revenue. Reduced revenue from high power CW lasers in cutting, welding and additive manufacturing applications was partially offset by strength in other materials processing applications. Pulsed lasers sales decreased 2% year over year, with rapid growth in solar cell processing and fine cutting offset by reduced sales for marking applications. Medium and low power laser sales decreased 50% on softness in additive manufacturing and the transition to kilowatt-scale lasers in cutting, while QCW sales declined 21% year over year due to softness in fine welding for consumer electronics versus the year-ago period. Systems sales increased 193% year over year including Genesis and 50% year over year excluding Genesis, driven by growth in macrosystems for welding and other materials processing applications. Other product sales decreased 9% year over year with growth in beam delivery accessories and service revenue more than offset by declines in communications and other laser products.

Gross margin of 49.5% declined 726 basis points from the second quarter 2018. Compared with the year-ago period, less favorable absorption of manufacturing expenses and foreign exchange reduced gross margin by 150 basis points. The acquisition of Genesis reduced gross margin by nearly 200 basis points. Higher inventory reserves reduced gross margin by 150 basis points and lower product pricing and other factors reduced gross margin by approximately 240 basis

points. Given the renewed uncertainty and increasing price competition, we have limited visibility and less confidence in getting gross margin back above 50% in the near-term. Holding other factors constant, we believe that recovery in our core laser business to more than $380 million in quarterly sales would enable us to get gross margin to 50%. Even at their current levels, our gross margins are industry leading.

Second quarter operating income was $91 million, or 25.0% of sales, down 1,430 basis points year over year. Excluding a foreign exchange loss of $5 million, operating margin was 26.4%. Excluding foreign exchange, operating expenses as a percentage of sales increased 600 basis points year over year due to: lower revenue; investments in engineers, salespeople and IT systems; and the acquisitions of Genesis and our Brazil submarine networks division.

Net income was $72 million and earnings per diluted share were $1.34. Foreign exchange losses reduced EPS by $0.08. If exchange rates relative to the US Dollar had been the same as one year ago, we would have expected revenue to be $18 million higher and gross profit to be $10 million higher. The effective tax rate in the quarter was 24%, which included certain discrete tax items.

We ended the quarter with cash, cash equivalents, and short-term investments of $1.04 billion and total debt of $44 million. Cash provided by operations was $58 million during the quarter. Operating cash flow was reduced by a $44 million outflow in accounts receivable related to the increase in revenue during the second quarter. Capital expenditures were $54 million, as we continue to invest in new plants and equipment to meet demand for our products over the next several years. During the quarter we repurchased 15 thousand shares for $2 million. We expect share repurchases to increase in the back half of 2019 and remain committed to offset dilution from equity issuance.

Turning to guidance, data points relating to the health of manufacturing economies in our largest regions have weakened over the last three months. Our second quarter book-to-bill ratio was above one, but below normal seasonality as order volumes weakened in June. Furthermore, the competitive environment remains challenging, due in part to the recent slowdown in industry demand levels. As a result, we expect pricing headwinds related to the competitive environment to continue. We expect growth in our innovative new products, accessories and complete systems to partially offset softness in our core business as these solutions gain further acceptance in the market.

Based on these factors, for the third quarter 2019 we expect revenue of $325 million to $355 million. We expect our third quarter tax rate to be approximately 25%. We anticipate delivering earnings per diluted share in the range of $1.05 to $1.35.

Escalation of the US-China trade conflict and further macro softness have reversed the market recovery we had expected to strengthen in the second half of 2019. Our largest machine tool OEM customers have not provided us with expectations beyond the next few months given the weaker macroeconomic and geopolitical climate. As a result, we do not have the necessary conviction to provide an outlook beyond the current quarter. However, we believe strength in new products and ongoing enhancements to our core laser portfolio will enable us to better capitalize on the eventual rebound in end market demand.

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.

James Hillier:

Thank you for joining us this morning and for your continued interest in IPG. We look forward to speaking with you over the coming weeks and on next quarter's call. Have a great day everyone.