IPG Photonics Corporation
Third Quarter 2019 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' third 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-Q for the quarter ended June 30, 2019 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 29, 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:

Good morning everyone. Our third quarter results were in line with our expectations. Despite the challenging macroeconomic backdrop and competitive landscape in China, we demonstrated good progress selling ultra high power fiber lasers, new exciting products, accessories and complete laser systems. Intensifying competition in the China cutting market resulted in greater than average price declines that outstripped growth in units and power. However, we continue to invest in new, unique products and applications to substantially enhance our competitive position and reduce product costs.

Along these lines, we were pleased to receive our first volume order for IPG lasers with high peak power capability. HPP products are capable of delivering peak energy twice the average power of the laser. This unique capability increases piercing and speed, improves cut quality, delivers cleaner, more controlled drilling of thicker materials and reduces scrap by enabling closer nesting of parts. In another example of our differentiated solutions, our adjustable mode beam lasers have now been accepted for a variety of welding applications in multiple regions. AMB permits the broadest range of beam tunability, simplifies setup and allows for the elimination of external optics. The spatterless welding capability of our AMB laser is particularly beneficial in electric vehicle battery production.

We have received encouraging feedback from customers evaluating the performance of our 20 kilowatt lasers using IPG high power cutting heads. These solutions significantly improve cutting speed for thin sheet metals over 15 kilowatt laser power while increasing the range of material thicknesses up to six centimeters that can be processed using laser technology. As another example of our differentiated portfolio, IPG offers the highest brightness through 50 micron core diameter fiber, at fiber lengths of up to 20 meters. In a six kilowatt laser, this provides our

customers with more than 70% higher productivity in cutting thin metals versus a competing laser in 100 micron fiber. Competitors in China do not offer a similar solution. At the low end of the cutting market, we will be introducing a new series of low cost lasers that we believe significantly enhance our competitive position and margin profile for these products.

Our ability to supplement leading laser solutions with high power optical heads is a key differentiator versus our laser competitors. Marrying this capability with LDD, our patented real-time weld monitoring solution, provides us with a unique offering in the welding market — one that can enable greater use of laser-based welding in automated production environments. Global automotive supplier Brose announced recently they are investing in our direct weld measurement technology to increase manufacturing efficiency. Beyond Brose, we recently received a significant order for battery welding that leverages this leading edge weld sensing and monitoring solution with our lasers and scanners. We are seeing strong customer interest for other opportunities as well.

Outside cutting and welding, we took orders for several products at industry leading power levels. Chief among these was a 120 kilowatt fiber laser order from a leading European research organization. This marks the most powerful CW fiber laser IPG has ever sold. We also took an order for a 100 kilowatt CW fiber laser for another research application. These two lasers should represent approximately $6 million of revenue in the fourth quarter. In addition, we took orders for 60 and 50 kilowatt CW lasers along with multiple 5 and 10 kilowatt single mode lasers. Collectively these products represent power levels and beam precision unmatched by the competition.

We continue to make progress in new product areas as well. Third quarter sales of newer laser products and systems into emerging applications grew 8% year over year and were 19% of total revenue, up from 16% one year ago. Sales within our medical laser business nearly doubled

year over year, driven by recent FDA approval for our thulium fiber laser solution in urology applications. Systems sales increased 14% year over year, excluding Genesis, driven by strong growth in IPG multi-axis and laser cube systems, ILT systems for medical device manufacturing and sales of our cinema projection system. Sales of ultrafast pulsed lasers grew year over year as we continue to pursue 50-plus projects across a wide range of micro processing applications. We believe our forthcoming introduction of a new 100 watt picosecond laser and new femtosecond products will help expand our presence in this market.

Despite the challenging environment, we continue to demonstrate progress in driving adoption of our laser technology in our core markets and in new product areas that expand our addressable market opportunity. Thanks to our dedicated workforce, total optical power shipped exceeded 13 megawatts in the third quarter, a testament to the acceptance of our fiber laser technology in the market. I remain confident in IPG's ability to execute during this period and emerge from the downturn in a strong competitive position, one with ample long-term opportunity to make our laser technology the tool of choice in manufacturing.

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 8% year over year to $329 million. Revenue from materials processing applications decreased 8% year over year and revenue from other applications increased 5%. Revenue in China decreased 24% year over year and represented approximately 37% of total sales. As we had expected, performance was impacted by weaker demand due to the US-China trade conflict and greater than average price declines. Overall price declines in Q3 moderated from the prior quarter.

In Europe, revenue decreased 10% year over year primarily due to softness in cutting, additive manufacturing and marking, partially offset by growth in welding. The demand environment in Europe remains very challenging, evidenced by weakening trends among key indicators of macroeconomic health in the region.

In North America, revenue increased 32% year over year driven by the acquisition of Genesis. Excluding Genesis, sales in North America increased 2% year over year with strong growth in welding, surgical and cutting applications offset by declines in our Menara communications business. Sales in Japan were flat with growth in welding and marking offset by weaker performance in cutting. Sales in Korea decreased 8% year over year but increased 10% sequentially as strength in battery welding was offset by softness in cutting and marking. Q3 revenue in Turkey decreased 20% year over year given macroeconomic pressures in the region.

Sales of high power CW lasers decreased 19% year over year and represented approximately 56% of total revenue. Reduced revenue from high power CW lasers in cutting and, to a lesser extent, welding was partially offset by strength in other materials processing applications. Pulsed lasers sales decreased 4% year over year, with growth in high power pulsed lasers offset by

reduced sales for marking applications. Systems sales increased 124% year over year including Genesis and 14% year over year excluding Genesis, driven by growth in systems for welding and other materials processing applications.

Medium power laser sales decreased 38% on softness in additive manufacturing and the transition to kilowatt-scale lasers in cutting, while QCW sales declined 32% year over year due to softness in fine welding for consumer electronics versus the year-ago period. Other product sales increased 28% year over year driven by growth in beam delivery accessories and service revenue.

Gross margin of 46.4% declined 830 basis points year over year. Compared with the year-ago period, less favorable absorption of manufacturing expenses and foreign exchange reduced gross margin by 270 basis points. The acquisition of Genesis reduced gross margin by 170 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.

In light of the current macroeconomic challenges, competitive landscape and our increasing systems revenue, we believe it is appropriate to moderate our target gross margin range to 45% to 50%. We are responding to the current business environment challenges with a multi-pronged strategy of product cost reduction, implementing differentiated features on our core products and leveraging the largest R&D investment in the laser industry to launch leading edge laser products for new markets. These measures in conjunction with modest market recovery, should increase the Company's industry-leading margin profile as compared with our current expectations for the fourth quarter.

Third quarter operating income was $74 million, or 22.5% of sales. Excluding a foreign exchange loss of $1 million, operating margin was 22.8%. Excluding foreign exchange, operating expenses

as a percentage of sales increased 410 basis points year over year due to lower revenue, acquisitions and investments in engineers, salespeople and IT systems.

Net income was $57 million and earnings per diluted share were $1.07. Foreign exchange losses reduced EPS by $0.01. 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 26%, which included certain discrete tax items.

We ended the quarter with cash, cash equivalents, and short-term investments of $1.08 billion and total debt of $43 million. Effective operational execution resulted in cash provided by operations of $92 million during the quarter. Capital expenditures were $21 million in the quarter and $108 million so far this year. As part of our operational review, we are reducing our annual outlook for capital expenditures to less than $150 million from prior guidance of $170 to $180 million. We also expect the level of capital expenditures to moderate next year. During the quarter we repurchased 181 thousand shares for $24 million.

During the fourth quarter IPG began implementing a cost reduction program in response to continued global macroeconomic, competitive and geopolitical headwinds. The Company expects to reduce annualized operating expenses by approximately $30 million, with the full impact being achieved as it exits the fourth quarter of fiscal 2019.

IPG is performing its annual assessment of goodwill impairment, which occurs in the fourth quarter each year. While this process is not yet complete, the Company currently expects that impairment charges will be recorded in the fourth quarter, primarily related to the communications business. The goodwill and other long-lived assets within the communications business that are subject to assessment total approximately $60 million.

Turning to guidance, as widely reported, demand for industrial automation equipment remains subdued. This market softness impacted our third quarter book-to-bill ratio, which was under 1.0 and below normal seasonality. Looking forward, we will rely on our core scientific strengths and strong cash flow to optimize investment in strategic initiatives critical to the long-term success of the Company, including a greater mix of high power lasers, differentiated features and new solutions. Furthermore, we intend to focus our highly trained workforce on our new leading edge, higher margin products as they gain market acceptance, while reducing the resources deployed to manufacture lower margin products. When combined with planned cost reductions, we believe this strategy will enable us to better compete today and to capitalize on the eventual rebound in end market demand.

For the fourth quarter 2019 we expect revenue of $270 million to $300 million. We expect our fourth quarter tax rate to be approximately 26%. We anticipate delivering earnings per diluted share in the range of $0.55 to $0.95. Our EPS guidance range includes approximately $0.02 impact from restructuring charges in the fourth quarter. This guidance excludes any EPS impact from charges that might arise from our annual assessment of goodwill impairment.

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, goodwill and other impairment charges, 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.