IPG Photonics Corporation
First Quarter 2020 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' first quarter 2020 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, Chief Operating Officer Dr. Eugene Scherbakov 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 the impact of the COVID-19 pandemic on our business and those detailed in IPG Photonics' Form 10-K for the period ended December 31, 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, May 5, 2020. 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. Before I discuss our results and strategic initiatives, I want to address how IPG is navigating the effects of the novel coronavirus outbreak.

The well-being of our people, our customers and our partners is our highest priority. IPG employees who can work from home are doing so. In all regions we continue to manufacture and service our solutions. Although there are some restrictions to US production, the impact to date has not been material given our products are used across a wide variety of critical infrastructure sectors. In Germany we did not stop work. In Russia production was stopped only for a one week vacation. In order to safeguard our people, we have employed additional distancing and cleaning measures in our facilities, sourced 100,000 masks for use in our production, introduced effective means for disinfection of air in all production areas and office rooms and temporarily increased wages for our hourly employees who continue to work on site. As a result, we are proud to report that IPG has not had any cases of COVID-19 infection across our worldwide locations in spite of more than 80% of our staff working on site the last several months.

IPG is contributing to the COVID-19 response efforts in local communities worldwide. In China, we have donated approximately 1 million RMB to help those affected by this worldwide epidemic, in the US we have donated tens of thousands of masks to local hospitals in need. In Russia we donated a modern CT imaging system to a local hospital as well as masks and other equipment. Eugene will discuss the impact of COVID-19 on our operations in greater detail. I want to assure you that at IPG, we are doing all we can to help safeguard our people and communities.

During this time of uncertainty, which is unlike any that we have faced before, it is unclear what will happen to global demand over the coming weeks and months. This uncertainty makes forecasting our business very challenging in the near- to medium-term. Nonetheless, our strong balance sheet, ample cash reserves and minimal debt provide us flexibility in responding to coronavirus-related disruptions and to emerge from the crisis with the ability to seize the many opportunities we expect to see. We plan to continue investment in strategic research and capital projects that will drive the next leg of market share capture for our fiber laser technology. Because our fiber lasers are a key enabler of automated precision manufacturing, we expect to disproportionately benefit from an eventual recovery in the industrial cycle.

Turning to results, we delivered first quarter revenue at the high end of our guidance range on better-than-expected performance in China and strength in new products. Despite the weaker demand environment, we have seen strong customer interest in a number of our leading-edge laser solutions. In cutting and welding applications, our ultra high power lasers at 12, 15 and 20 kilowatts have demonstrated superior attributes to competing products including faster cutting and welding speeds, better beam parameters, higher wall plug efficiency and significantly better reliability. IPG lasers continue to deliver peace of mind and lower lifetime costs, while enhancing end user productivity. We received our first volume order for our Adjustable Mode Beam lasers for electric vehicle battery welding. As a reminder, our AMB lasers permit the broadest range of beam tunability, enabling spatterless welding. In addition, we more than doubled sales of high power nanosecond pulsed lasers at 300 and 500 watts used for foil cutting in electric vehicle battery processing applications. IPG remains the only reliable laser source supplier of these products, and we continue to expect strong growth in this application during the year.

Product innovation remains core to IPG's success. During the first quarter emerging product and application sales were 23% of total revenue, increasing more than 20% year over year despite a

softer demand environment for IPG laser systems due to COVID-19. Sales of green pulsed lasers used to improve solar cell efficiency increased by more than 50% year over year. Sales of ultrafast pulsed lasers increased modestly as customer acceptance and traction was curtailed by the uncertain demand environment. However, we continue to target 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 medical lasers were a record $10 million in Q1, increasing more than 500% year over year. We continue to ramp sales of our thulium laser solution for urology and other soft tissue applications from the partnerships we seeded several years ago and an FDA approval late last year. Our medical laser business includes sales of consumable fibers, a recurring revenue stream that will grow as the number of installed systems increases. Advanced applications revenue more than doubled year over year, with strong growth in government, semiconductor and scientific applications. We will continue to invest in transformative new products, including new medical treatments, mid-infrared lasers for spectroscopy, inspection and sensing applications, ultra high power single mode lasers for aerospace and defense. These new solutions will enhance our growth and margin profile and provide greater geographic and end market diversification.

Finally, I want to express my gratitude to the IPG team for their outstanding performance during this most challenging time. In particular, I want to recognize our production employees and other IPG colleagues who come to work each day, enabling us to manage though this crisis. I believe their execution, combined with our laser technology leadership and robust balance sheet will enable IPG to capitalize on the long-term secular growth in laser technology and 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 Eugene.

Eugene Scherbakov:

Thank you Valentin and good morning everyone.

I will begin by discussing the effects of COVID-19 on our production. Currently all three of our major production facilities in Germany, the US and Russia remain open. However, we have scaled back production in Massachusetts to those products required to support essential businesses. These include lasers and laser systems used in the transportation, medical, agricultural, communications and defense end markets, among others. Our German operations are operating on a more normalized basis, albeit with social distancing measures in place. In Russia our employees are working on a rotating basis to limit contact. Our highest priority remains the safety of our employees, their families, our business partners and community. And as Valentin noted, we have put in place additional health, safety and workplace measures to safeguard the health and well-being of our valued employees and colleagues.

Our vertically integrated production model continues to provide us with critical advantages in this time of supply chain disruptions. Although we source certain raw materials from third parties, we internally produce the more complex components and modules used in our technology. Our leading edge components and modules are the critical technical, performance and cost differentiator between IPG and our competition. We continue to leverage this advantage developed from more than 20 years of investment in technology, people and processes. Many of our third-party suppliers remain open providing us the components we need. However, the supply chain constraints we face are primarily related to logistics, including available air cargo space and higher freights rates. Available cargo space on flights between the US and Europe

and Europe and Asia is more limited so shipments are taking longer. In addition, shipments within Europe are limited within the countries worst affected by COVID-19 and experiencing some delays in other places due to checks at border crossings. Recognizing that this situation is fluid and subject to change, we believe we have the ability to meet the near-term demand for our products.

In total manufacturing and operating expenses were approximately $20 million lower in Q1 compared to their peak level in Q2 2019. Although some of this reduction is due to a lower level of activity, it is primarily attributable to the cost reduction actions we undertook in the second half of 2019. We remain committed to managing our cost structure and working capital to the business environment.

Examining our performance by region, revenue in China decreased 40% year over year and represented approximately 28% of total sales. As we had expected, performance was impacted by weaker demand due to the novel coronavirus outbreak, though we did see a strong recovery in orders during the latter half of March and April. We continue to face aggressive price competition in the region; however, pricing was more stable on a sequential basis.

In Europe, where the industrial demand environment remains very challenging, revenue decreased 15% year over year. Revenue in North America increased 4% year over year with strong growth in medical lasers and advanced applications. Our growth in North America illustrates the benefits of our diversified portfolio strategy where increasing adoption of emerging laser solutions and applications offset softness within industrial markets. Sales in Japan decreased 12% year over year given ongoing macroeconomic

weakness in the region. Sales in Korea decreased 26% year over year due to the effects of COVID-19 within the region and sales in Turkey decreased 37% year over year due to the virus and other macroeconomic challenges affecting cutting business in the region.

With that, I'll turn the call over to Tim to discuss financial highlights in the quarter.

Tim Mammen:

Thank you Eugene and good morning everyone.

Revenue in the first quarter declined 21% year over year to $249 million. Revenue from materials processing applications decreased 28% year over year and revenue from other applications increased 123%. Sales of high power CW lasers decreased 33% year over year and represented approximately 48% of total revenue. Sales of ultra high power lasers at six kilowatts or greater represented nearly 50% of total high power CW laser sales. Pulsed lasers sales increased 1% year over year, with growth in green and high power pulsed lasers partially offset by lower sales of lower power pulsed lasers for marking applications. Systems sales decreased 43% year over year as growth in systems for medical device manufacturing was offset by lower sales of other IPG laser systems and Genesis non-laser systems. Medium power laser sales decreased 28% on continued softness in additive manufacturing and the transition to kilowatt-scale lasers in cutting, while QCW laser sales decreased 30% year over year. Other product sales increased 38% year over year driven by growth in medical laser sales and total service revenue.

Q1 GAAP gross margin was 41%, which declined 600 basis points year over year. Compared with the year-ago period, the year over year decline in gross margin was driven by the following factors: 200 basis points from less favorable absorption of manufacturing expenses; 190 basis points from higher inventory reserves; 90 basis points from an increase in shipping costs; 20 basis points from foreign exchange and 100 basis points from other factors including lower product pricing.

First quarter GAAP operating income was $45 million and operating margin was 18%. During the quarter we recognized a foreign exchange gain of $20 million primarily related to revaluation of US dollar cash and other assets in Russia given the depreciation of the Ruble versus the US

dollar. Excluding this foreign exchange gain, operating margin was 10%. Q1 net income was $36 million or $0.68 per diluted share. The previously referenced foreign exchange gains increased EPS by $0.28. The effective tax rate in the quarter was 23%.

If exchange rates relative to the US Dollar had been the same as one year ago, we would have expected revenue to be $5 million higher and gross profit to be $3 million higher.

We ended the quarter with cash, cash equivalents, and short-term investments of $1.2 billion and total debt of $41 million. As Valentin noted earlier, our strong balance sheet provides us with ample flexibility in responding to coronavirus-related disruptions, particularly around investing for future growth opportunities. Effective operational execution resulted in cash provided by operations of $57 million during the quarter. Capital expenditures were $18 million in the quarter and trending below our target of $115 million to $125 million for 2020. During the quarter we repurchased 109 thousand shares for $13 million.

Today, IPG also announced that its Board of Directors has authorized the purchase of up to $200 million of IPG common stock in open market transactions or otherwise, subject to market conditions and other relevant factors. This new authorization is in addition to the company's existing $125 million stock repurchase program authorized in February 2019, of which approximately $60 million remains available under that prior program.

In March and April, we extended our credit lines with Bank of America and Deutsche Bank for five and three additional years, respectively. Bank of America also increased the total unsecured availability to $75 million from $50 million.

First quarter book to bill was meaningfully greater than 1.0, and above normal seasonality reflecting solid bookings growth and the weaker revenue quarter in China. Normally this would have translated into stronger guidance for the second quarter, but the global demand environment remains very uncertain given the effects of COVID-19 on manufacturing facilities and customer confidence around the world. While we have seen a rebound in China-based order volumes in the latter half of March and April, this has coincided with declining bookings in other regions, including Western Europe, North America and other countries in Asia. As such, visibility into a recovery in global demand remains uncertain at this time. Despite the uncertain near-term demand environment, we continue to target significant longer-term growth opportunities in laser welding, electric vehicle battery processing and our portfolio of new products. Our strong balance sheet will help us through the crisis and emerge with the ability to capitalize on the many opportunities we have ahead.

For the second quarter of 2020, IPG expects revenue of $260 million to $290 million. The company expects the second quarter tax rate to be approximately 26%. IPG anticipates delivering earnings per diluted share in the range of $0.40 to $0.70, with 53.1 million basic common shares outstanding and 53.7 million diluted common shares outstanding. Financial guidance provided this quarter is subject to greater risk and uncertainty given the COVID-19 pandemic and its associated impacts to the global business environment and government policies.

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, health epidemics 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, Eugene 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 will be participating in a number of virtual investor conferences this quarter. Have a great day and stay safe everyone.