IPG Photonics Corporation
Third Quarter 2020 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' third quarter 2020 conference call. Today's call is being recorded and webcast. At this time, I would like to turn the call over to Angelo Lopresti, IPG's Senior Vice President and General Counsel, for introductions. Please go ahead sir.

Angelo Lopresti:

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, October 30, 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. We demonstrated excellent execution in the third quarter and delivered results above our guidance range despite continued challenges from the COVID-19 pandemic and general economic slowdown. Our out-performance was driven by two factors. First, strong revenue in China, which improved slightly from a strong second quarter and increased meaningfully from the third quarter of 2019. And second, a sequential improvement in Europe, which recovered from the low point of the second quarter 2020. Economic indicators show improvement from the significant contraction in activity in the second quarter and this helped to drive improved performance in the third quarter.

Sales of high power lasers above 6 kilowatt increased more than 15% compared to the third quarter of 2019. Revenue from other applications increased by 24% primarily from higher revenue from advanced applications which was driven by revenue from high power single mode fiber lasers and medical procedures.

We are demonstrating good progress in our core markets thanks to our technology differentiation and low cost production capabilities. In the cutting market, we delivered strong year-over-year growth in both our rack mounted 1 to 4 kW lasers for the high-volume market and our ultra-high power lasers for leading-edge cutting systems. Ultra-high power lasers made up more than 58% of total high power sales. Our customers are working on integrating the new ultra-compact rack mounted U series of lasers into their low cost cutting systems, and we expect to receive the first volume orders in the coming months. The new U Series has extended optical performance, with the smallest size, lowest weight in the industry and record power to volume ratio. For the first time, this range of devices provides full protection against humidity penetration that is extremely important in field usage.

At the high end of the market, we are benefiting from an increase in order volumes for our 20 and 30 kw ultra-high power lasers and optical heads. These lasers not only enable 50% to 100% faster cutting speeds than a 15 kw device, but are capable of processing materials with 20 to 50 millimeters of thickness or greater. This improvement in both productivity and flexibility is driving the replacement of plasma cutting machines and lower power laser solutions. This is particularly true in machine shops and construction equipment manufacturing. Moreover, these lasers provide superior beam parameters, record wall plug efficiency and unique high reliability that are the hallmarks of the IPG brand. They also drive a superior return on investment for our customers.

Our Adjustable Mode Beam lasers continue to gain traction in the welding industry, most notably in electric vehicle battery welding. Our AMB products offer superior speed and weld quality over competing solutions thanks to the broadest range of beam tunability. This enables spatterless welding. In addition, we continue to expect strong growth for our high power nanosecond pulsed lasers used for foil cutting and cleaning in electric vehicle battery processing as well as for ablation and cleaning in other industries.

Product innovation remains core to IPG's success. During the third quarter emerging product and application sales were 21% of total revenue, increasing 5% year-over-year despite softer demand trends due to the COVID-19 in several new product categories including systems. Sales of medical lasers increased more than 30% year-over-year as we continue to sell our "gold standard" thulium laser solution and consumable fibers for urology and other soft tissue applications. Advanced applications revenue increased 50% year-over-year in Q3 driven by strength in government and semiconductor applications.

Despite the impact of COVID-19 pandemic, sales of green, ultraviolet and ultrafast pulsed lasers into emerging micro processing applications showed strong growth year-over-year. In addition,

we have a very strong backlog of green lasers and improved backlog for UV and ultrafast pulsed lasers as a result of orders received in the third quarter. Our green pulsed lasers are enabling significant improvements in solar cell efficiency. We continue to target more than 50 new projects for these lasers across a wide range of applications. These include processing of glass, ceramics, composite materials, numerous crystals, circuit boards, OLED film, batteries and solar cells.

We are investing in a number of next-generation solutions with significant disruptive potential that we plan to launch over the next six to twelve months. Customer evaluation of our handheld laser welder has been very positive, and they have cited improvements in weld quality, diversity of materials that can be joined and programmed welding parameters for different types and thickness of materials as advantages. The multichannel QCW lasers for high speed spot welding applications have the potential to be disruptive in displacing very inefficient Nd:YAG lasers. This is due to the significant cost savings they can bring due to an increase in welding productivity and decrease in electrical consumption. Our kilowatt-scale pulsed lasers for ablation and cleaning applications are also continuing to gain acceptance. Beyond materials processing, we continue to develop new soft tissue medical treatments, mid-infrared lasers for molecular-level resolution online spectroscopy, inspection, sensing and biomedical research applications and new high-speed transceivers for the telecom and datacom markets.

I want to conclude by thanking our employees for their strong execution during one of the most challenging periods in our company's history. The diligence of our employees to keep each other safe has enabled us to return our operations back to normal within safety guidelines. Of course the well-being of our employees, their families, our customers, our partners and our community remains our highest priority.

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

Eugene Scherbakov:

Thank you Valentin, and good morning. I will begin by discussing the effects of COVID-19 on our production. All three of our major production facilities in Germany, the US and Russia remain open and are operating normally, and we have not seen any disruption to our manufacturing or service capabilities in the regions where we operate. Our global facilities are operating on a largely normalized basis, albeit with social distancing and enhanced cleaning and filtration measures in place.

In addition, we were back to normal operations promptly after we reported the ransomware attack in September. The incident did not have a material impact on our business, operations, financial condition or our ability to report financial results. As we disclosed earlier, we carry cyber insurance to cover this type of risk. Nonetheless, IPG is conducting an analysis to improve the security and resiliency of our systems.

We continue to benefit from our vertically integrated production model which enables key technological and cost advantages over the competition while minimizing supply chain disruptions. The current constraints on our business primarily relate to restrictions on travel that affect our sales team and customer visits related to applications development. Logistics were less impacted in the third quarter, and we did not encounter any meaningful disruption in our ability to ship components and finished product around the world. As a percent of sales, shipping costs were slightly lower than they were in the second quarter.

We continue to benefit from reducing the cost of devices and from the expense reduction initiatives we undertook in the second half of 2019. Gross margin improved to

48% this quarter. Total SG&A and R&D expenses increased by $2.8 million to $78 million in the third quarter compared to $75.3 million in the second quarter while sales revenue increased by $22 million. Operating expenses continue to track well below the peak level of $84 million incurred in the second quarter of 2019.

Examining our performance by region, revenue in China increased 22% year-over-year, representing approximately 47% of total sales. New orders booked in China were slow at the beginning of the quarter but picked up in September. However, China continues to have a significant backlog given the exceptional level of orders booked in the first half of the year. While we face aggressive competition in the region for lasers at 6kW and below, we continue to maintain share at key accounts while anticipating a strong mix of lasers at 10 kW or greater in the future.

In Europe, revenue decreased 10% year-over-year due to the effects of COVID-19 on many countries in the region. Similarly, revenue in North America decreased 26% year-over-year with strong growth in medical lasers and advanced applications not being sufficient to offset declines in laser and systems sales for materials processing. While North American revenue was weak in the third quarter it was notable that order bookings were exceptional and benefited from several large orders for advanced applications and for our unique green lasers used in renewable energy. Sales in Japan decreased 41% year-over-year. While COVID-19 infections in the region are below other countries, the recurring stop and restart of economic activity has delayed many significant projects within our welding and cutting businesses in Japan. Sales to the rest of Asia increased 6% year-over-year as they recovered from the second quarter trough and also benefited from the shipment of high-power lasers for advanced

applications. Sales in Turkey increased 15% year-over-year and by more than 100% as compared to the second quarter.

Global demand trends remain uncertain and we have seen continued delays of projects globally, which makes the execution in the third quarter all the more notable. We continue to believe that our large and diverse advanced materials and components technology platform, our efficient R&D model and our strong balance sheet and free cash flow provide us ample flexibility to respond to business disruptions and emerge from the pandemic in a stronger competitive position.

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 third quarter was $318 million, which declined 3% year-over-year but increased 7% quarter-over-quarter. Revenue from materials processing applications decreased 5% year-over-year and revenue from other applications increased 24%. Sales of high-power CW lasers were flat year-over-year and represented approximately 58% of total revenue. Sales of ultra-high power lasers at 6 kw or greater represented 58% of total high-power CW laser sales. Pulsed lasers sales increased 3% year-over-year, with strong growth in green pulsed lasers used in solar cell manufacturing as well as higher sales of our new UV and ultrafast pulsed lasers which were partially offset by lower sales of lower-power pulsed lasers for marking applications. Systems sales decreased 37% 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 1% on continued softness in additive manufacturing and the transition to kilowatt-scale lasers in cutting. QCW laser sales increased 21% year-over-year from sequential improvement in consumer electronics applications. Other product sales increased 8% year-over-year driven by growth in medical laser sales.

Q3 gross margin was 48%, which increased 160 basis points year-over-year. Compared with the year-ago period, the increase in gross margin was driven primarily by lower cost of products, which was offset by an increase in inventory provisions as compared to the year-ago period.

Third quarter GAAP operating income was $41 million and operating margin was 13%. Goodwill impairment charges related to Genesis Systems Group reduced operating income by $45 million and reduced operating margin by 14 percentage points. The results of this business were impacted by lower capital investments from industries impacted greatly by the COVID-19 pandemic, such as aerospace and transportation, as projects have been delayed. We continue

to be focused on numerous opportunities for Genesis including transitioning to a higher percentage of laser-based systems as well as expanding the international systems opportunities. We are hopeful that it will ultimately enable progress to be made on broader-based laser welding applications across many different industries.

During the quarter we recognized a foreign exchange gain of $11 million primarily related to revaluation of US dollar cash and other assets held in Russia given the depreciation of the Ruble versus the US dollar and to the appreciation of Chinese Yuan. The foreign exchange gain increased Q3 operating margin by 350 basis points. Q3 net income was $36 million, or $0.66 per diluted share. The goodwill impairment charge reduced EPS by $0.63, while foreign exchange gains benefitted EPS by $0.15. The effective tax rate in the quarter was 16%.

If exchange rates relative to the US Dollar had been the same as one year ago, we would have expected revenue to be $4 million lower and gross profit to be $3 million lower.

We ended the quarter with cash, cash equivalents, and short-term investments of $1.3 billion and total debt of $39 million. Strong operational execution resulted in cash provided by operations of $70 million during the quarter. As a result of COVID-19 we have reduced our planned capital expenditures for the year. Capital expenditures were $25 million in the third quarter and we now expect capital expenditures will be in the range of $80 million to $100 million for the full year. During the quarter we repurchased 61 thousand shares for $10 million.

Bookings growth in North America and Europe was strong compared to the second quarter while total orders in China were lower. In North America, we had record bookings aided by several orders for advanced applications and emerging applications. While total orders in China for the third quarter were lower, China continues to have a significant backlog given the exceptional level of orders booked in the first half of the year. In total, third quarter book-to-bill was slightly below 1. Overall, it was also notable that order bookings improved markedly during September.

It is difficult to predict whether the improvement in some macro-economic indicators will be sustained given the resurgence of COVID-19 in Europe and North America and its potential impact on economic activity. These uncertainties continue to make forecasting our business challenging in the near- to medium-term. That said we continue to benefit from near-term growth opportunities in ultra-high power cutting, electric vehicle battery processing, medical procedures and advanced applications. We believe the strides we are making in higher-power products within our core materials processing business and new solutions will enable us to emerge from the current downturn in a stronger competitive position.

For the fourth quarter of 2020, IPG expects revenue of $290 to $320 million. The Company expects the fourth quarter tax rate to be approximately 25%. IPG anticipates delivering earnings per diluted share in the range of $0.75 to $1.05, 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, public health requirements and government mandates.

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.