IPG Photonics Corporation
Third Quarter 2022 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' third quarter 2022 conference call. Today's call is being recorded and webcast. At this time, I would like to turn the call over to Eugene Fedotoff, IPG's Director of Investor Relations, for introductions. Please go ahead sir.

Eugene Fedotoff:

Thank you operator, and good morning everyone. With me today is IPG Photonics' CEO, Dr. Eugene Scherbakov and Senior Vice President and CFO, Tim Mammen. Let me remind you that 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 are detailed in IPG Photonics' Form 10-K for the period ended December 31, 2021 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 as of today, November 1, 2022, only. 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, earnings call presentation and the Excel-based financial data workbook posted on our investor relations website. We will post these prepared remarks on our investor relations website following the completion of this call. With that, I'll now turn the call over to Eugene Scherbakov.

Eugene Scherbakov:

Good morning everyone. We continued to see upward momentum in our emerging growth products in the third quarter. We saw strong results in welding, cleaning, solar cell manufacturing, medical and 3D printing applications. These were offset by a number of headwinds, including the unfavorable impact of foreign currency, weaker economic conditions in Europe and Covid-related lockdowns in China. Softness in general industrial demand in Europe and China negatively impacted sales in high power cutting applications. At the same time, we saw modest growth in North America and were pleased with continued increase in e-mobility sales, driven by new investments in electric vehicle battery capacity across all geographies.

Emerging growth product sales were 43% of our total revenue in the third quarter. Many of these products are benefiting from global macro trends such as e-mobility and automation as well as increased focus on sustainability, renewable energy and energy efficiency. More specifically, we saw record sales in AMB lasers, driven by growth in EV battery welding. We also saw strong demand in our green lasers for solar cell manufacturing applications. This market is rebounding, driven by increasing investments in renewable energy solutions globally. Additionally, the revenue for lasers used in cleaning applications, which provide sustainability benefits by reducing use of abrasives and chemicals, grew significantly this quarter.

In August, we announced the sale of our telecom transmission business as the business required additional investments and was non-core to IPG. This divestiture had only a minor impact on sales, but will meaningfully reduce our operating expenses going forward. I believe that the sale of telecom business and the decision to exit our cinema business will allow IPG to focus R&D and other resources on core growth opportunities, such as e-mobility, welding, and medical.

Now, I will go over each of these core opportunities in more details. We had another great quarter in EV applications as revenue and orders increased across all geographies. There are additional investments into EV batteries planned in Europe and North America and we are seeing increased activity in the U.S. due to the recently-announced government incentives. Third-party estimates suggest that global lithium-ion battery capacity will triple by 2025 and may reach 6 terawatts by 2030, a sevenfold increase compared to the 2021 level. This growth in battery capacity presents a significant addressable market for our lasers.

To focus on global EV opportunities, we implemented some organizational changes and increased our sales and marketing capabilities. IPG has a leading position in welding and foil cutting applications for EV batteries. We offer a broad range of solutions to customers from laser sources to complete production lines for existing and emerging battery technologies. We sold several complete systems and production lines for R&D and experimental batteries in the quarter. We continue to introduce and are seeing strong initial demand for our picosecond and ultra-high power pulsed lasers. IPG recently increased its product offering in e-mobility applications with new QCW AMB lasers which offer excellent performance and displace green and blue laser solutions that cost more and are more complicated to integrate. We continue to explore additional opportunities in foil cutting and electrical motor assembly. The adoption of IPG's beam delivery and real-time welding monitoring software has been very successful in e-mobility applications. The EV-related revenue is accounting for approximately 20% of our total sales in the quarter, up from 10% of 2021 sales. We expect the EV investment cycle to continue and e-mobility sales to remain strong in the next 3 to 5 years despite less favorable outlook for the global economy in the near term.

This was another record quarter for welding revenue that not only benefited from growth in electric vehicle batteries, but also growth in LightWELD sales. LightWELD is still on early stages of its growth trajectory, rapidly increasing sales and orders globally in markets currently dominated by non-laser technology. We have received a CE mark and started selling LightWELD in most of the larger European countries in the third quarter. We have established distribution partners and continue to see high interest from the welding community during trade shows. LightWELD handheld welder is a superior tool for small and mid-size fabricators that brings ease of use to the welding process. Additionally, IPG is also working with automation companies to introduce a cobot-LightWELD combination that helps customers to implement automation of welding processes at a relatively low cost.

Our medical business also had another record quarter with revenue increasing more than 70% year over year and showing continued growth in bookings. Our thulium laser and consumable fiber for urology applications, which are considered a new gold standard, continue to replace holmium laser, rapidly gaining adoption in the urology market. As we grow the number of installed units, recurring revenue from consumable fiber is also growing. I am pleased to see that we are well ahead of our target to double the business in 2 to 3 years as our medical revenue should approach $70 million this year, up from $43 million last year.

Before I turn the call to Tim, let me provide an update on our operations in Russia. During the first nine months in 2022, we managed to navigate the complex and evolving regulations, including sanctions, without material disruption to our ability to meet customer demand. We are continuing to increase manufacturing capacity and build safety stock of critical components in the United Stated and Europe. In addition we have started purchasing many less-critical components from third parties that were qualified earlier this year. Recently, the EU has announced a new package of sanctions and new license requirements which place even more limitations on trade with Russia, essentially curtailing our ability to import components to our European facilities and export items to our Russian facility, effective early January of next year. We believe that the contingency plans we are executing will enable us to eliminate our dependence on Russian production before the new European sanctions take full effect. We will continue to monitor the situation closely and, with our Board of Directors, are assessing the strategical options for our Russian facilities.

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

Tim Mammen:

Thank you Eugene, and good morning everyone. My comments generally will follow the earnings call presentation which is available on our investor relations website. I will start with the financial review on slide 4.

Revenue in the third quarter was $349 million, a decline of 8% year over year due to foreign currency headwinds, which accounted for approximately 7% of the decline. We also saw lower sales in China, Europe and Japan, primarily in general industrial applications. Our sales in North America were slightly higher year over year. Revenue from materials processing applications decreased 10% year over year and revenue from other applications increased 10%.

GAAP gross margin was 43.1%, a decrease of 590 basis points year over year, due to increased cost of products sold, higher inventory reserves as well as higher shipping costs and tariffs. We did see slightly better absorption of manufacturing costs in the quarter as we continued to increase our inventories of safety stock. In the long-term, we remain committed to our gross margin target of 45% to 50%.

If exchange rates relative to the U.S. dollar had been the same as one year ago, we would have expected revenue to be $26 million higher and gross profit to be $14 million higher.

GAAP operating income was $93 million and operating margin was 26.7%. Net income was $76 million, or $1.47 per diluted share. The effective tax rate in the quarter was 21%.

Foreign currency transaction gains related to remeasuring foreign currency assets and liabilities to period-end exchange rates, had only a minor positive impact on the operating expenses of less than $1 million. At the same time, we had several unusual items in the quarter. There was a $22 million or $0.32 per diluted share gain on sale of the telecom transmission business and $1 million or $0.01 per diluted share restructuring charge related to shutting down the remaining

telecom business. Excluding the currency transaction gain, gain on sale of assets and restructuring charge, operating expenses declined year over year, primarily in research and development as we reduced spending on telecom product development following the sale and restructuring of the business. We also are looking at ways to further reduce our expenses, including sale of the corporate aircraft and two underutilized buildings. Freed-up resources will be available for activities that are core to our strategy.

Moving to slide 5. Sales of high power CW lasers decreased 14% and represented approximately 44% of total revenue. Sales of ultra-high power lasers above 6 kW represented 45% of total high power CW laser sales. The decline was primarily due to lower demand in cutting applications in China and Europe as a result of lower economic activity that negatively impacted demand in general industrial applications. Pulsed lasers sales decreased 6% year over year due to lower demand in cutting and marking applications partially offset by strong sales into solar cell manufacturing and cleaning applications. Systems sales increased 10% year over year driven by growth in laser systems and higher sales of LightWELD. Medium power laser sales decreased 16% while QCW laser sales were down 30% year over year, negatively impacted by lower sales to consumer electronics applications. Other product sales increased driven by record sales in medical applications.

Looking at our performance by region on slide 6, revenue in North America increased 1%, driven by growth in cutting, welding and medical applications, which was offset by lower sales in non-laser systems as well as the telecom divestiture.

In Europe, sales decreased 13% as a result of lower demand across all major materials processing applications and the weaker Euro. Customers are delaying projects as a result of high energy costs and economic uncertainty in Europe. However, e-mobility orders remain strong despite overall softness in the economy.

Revenue in China decreased 14% year over year as growth in welding for EV battery applications and 3D printing applications was offset by Covid-related lockdowns, continued softness in the cutting market and currency headwinds.

Moving to a summary of our balance sheet on slide 7, we ended the quarter with cash, cash equivalents, and short-term investments of $1.2 billion and total debt of $16 million. Cash provided by operations was $76 million during the quarter and capital expenditures were $25 million in the quarter.

While continuing to maintain a strong balance sheet, we have returned a significant amount of capital to shareholders with our ongoing stock repurchases this year. During the quarter, we repurchased shares for a total of $71 million. Most of the repurchasing in the third quarter happened in the second half of September as we had a cooling-off period between our 10b5 programs. We continued to repurchase shares in October. Since the beginning of the year, IPG repurchased shares for $383 million as of the end of the third quarter and approximately $440 million year to date.

Our capex has been trending below our initial expectations and we will likely finish the year at approximately $110 million, well below our previous guidance of $130 million to $140 million.

As Eugene mentioned earlier, we are assessing strategic options for our Russian operations. In addition, we are evaluating the effect of the new sanctions on our ability to recover the value of our working capital and long-lived assets located in Russia. As of the end of the third quarter, we had approximately $44 million in cash and short-term investments and approximately $150 million in working capital, including $116 million in inventory in Russia. The net value of long-lived assets in Russia is approximately $95 million.

Moving to outlook on slide 9, third quarter book-to-bill was slightly above 1. We saw further moderation of orders in Europe as well as reduced bookings in China, primarily due to softening macroeconomic conditions which impacted demand in general industrial markets. However, we are seeing continued strong orders in e-mobility and medical applications as well as more stable operating conditions in North America. We continue to benefit from growth opportunities created by major macro trends such as electric vehicle battery manufacturing and renewable energy. In addition, LightWELD and medical sales further diversify our revenue. We believe these trends and diversity will enable us to weather downturns in the economy with greater resiliency.

For the fourth quarter of 2022, IPG expects revenue of $300 to $330 million. The Company expects the fourth quarter tax rate to be approximately 25%. IPG anticipates delivering earnings per diluted share in the range of $0.70 to $1.00, with approximately 51 million diluted common shares outstanding. We continue to expect currency headwinds and estimate that the fourth quarter revenue guidance range is reduced by about $28 million due to the strength of the U.S. dollar in the current quarter as compared to the fourth quarter 2021.

As discussed in the "Safe Harbor" passage of today's earnings press release, 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 "Safe Harbor" and the company's reports with the SEC.

With that, we will be happy to take your questions.

Eugene Fedotoff:

Thank you for joining us this morning and for your continued interest in IPG. We will be participating in a number of investor events this quarter and are looking forward to speaking with you over the coming weeks. Have a great day everyone.