IPG Photonics Corporation
Fourth Quarter 2022 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' fourth 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, February 14, 2023, 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. I am pleased to report that we continued to see strong momentum in our focus areas such as e-mobility, welding and medical in the fourth quarter and finished the year with revenue above our guidance range, despite a challenging operating environment and currency headwinds. Our strategy to diversify revenue as evidenced by the performance of emerging growth products and applications is paying off. As we moved through the year, we continued to see record sales in e-mobility, medical and welding, including handheld welding applications. Our team has done an outstanding job diversifying the business and finding growth opportunities.

Emerging growth product sales were 46% of our total revenue in the fourth quarter. Demand for many of these products was driven by global investments in e-mobility and renewable energy. IPG is well-positioned to benefit from accelerating global EV battery capacity expansion and our EV sales contributed close to 20% of total revenue in 2022, up from around 10% a year earlier. We believe that the battery capacity build-out will accelerate in North America and Europe and will continue to increase in China in the next several years to support growing EV sales. More recently, customers shifted investments into the U.S. to take advantage of government incentives, which drove higher levels of activity in the region. Our leading position in fiber lasers with a broad range of solutions including welding, cutting, cleaning and process monitoring has allowed us to capture the growth in these markets. We have recently introduced high wall plug efficiency laser drying solutions for use in battery foil manufacturing, the largest CO2 producing process step of battery manufacturing. The solution replaces less efficient infrared bulbs and environmentally unfriendly gas-fired furnaces. It can significantly reduce energy costs and increase drying speeds for our customers.

We are particularly pleased with our growth in welding applications in the fourth quarter. Welding now accounting for over 30% of our materials processing revenue and grew approximately 40% year over year, surpassing in size flat-sheet cutting revenue, a milestone for us. This growth was driven by strong demand for our welding solutions in e-mobility and medical device welding, continued adoption of laser welding in general industrial markets, growth in laser-based systems and a roll-out of LightWELD. EV battery manufacturers have quickly adopted laser welding as it provides high-quality and high-speed welding with real-time process monitoring capabilities. The rest of the $20 billion welding market is still early in the adoption of laser technologies, but we are starting to see a more meaningful shift towards acceptance of lasers and believe that this will continue. A large portion of the welding market is using traditional manual welding, primarily with MIG or TIG devices. Traditional welding is very limited in types of materials it can join and requires highly skilled welders to do the job. LightWELD addresses many of these challenges with an ability to join a broad range of materials, including some hard-to-weld metals such as aluminum alloys, copper, titanium and thin foils. LightWELD can also increase welding speeds by up to 4 times and does not require extensive training. According to American Welding Society, there is a deficit of 375 thousand welders. LightWELD is easy to use and comes with presets for different types of materials which can result in faster training for unskilled welders required to fill the employment gap. We are working with a number of training schools to increase awareness and adoption of laser welding. We also continue to build our LightWELD organization and have established distribution partners to support international sales, which should drive growth in LightWELD sales in 2023.

Our laser cleaning solutions have been gaining traction and we have a strong backlog of customer orders for new systems that are providing fully automated cleaning and can significantly reduce time and use of harmful materials for surface preparation as well as rust and paint removal. This process typically uses harmful chemicals such as acids or solvents that are being banned around the world. Our lasers can do surface preparation quicker and with less harm to the environment.

Finally, our medical business delivered record revenue in the fourth quarter, finishing a very strong year on a high note. Full-year revenue grew over 60% in medical, driven by higher adoption for our thulium laser used primarily in urology applications. Our consumable fiber business now accounts for a sizable portion of the revenue and we expect it to increase further as we grow the installed base of the devices. We continue to expand medical sales internationally and we are working on the next generation of these devices as well as new medical applications for our fiber lasers.

While 2022 was a challenging year for IPG, we successfully navigated the choppy waters. We faced continued soft demand in high power cutting in China, currency headwinds due to a strong U.S. dollar, supply chain disruptions as well as restrictions on shipments of components from our manufacturing facility in Russia. IPG's performance in 2022 is a tribute to the dedicated team of employees and partners throughout the world and their efforts overcoming supply chain constraints and a complex regulatory environment to deliver products to our customers. And while there is still uncertainty in the operating environment with fears of a slowdown in North America and further weakness in Europe, we believe that IPG is well positioned to benefit from investments in e-mobility, renewable energy and automation. This is reflected in our record backlog which gives us reason to be optimistic for the year. We are hopeful to see a recovery in demand in China this year as Covid-related restrictions are being relaxed.

We believe customers are choosing our lasers and systems because they save customers energy and are more sustainable solutions with less environmental impact than competing processes and technologies.

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. 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 fourth quarter was $334 million, down 8% year over year due to foreign currency headwinds, which accounted for approximately 7% of the decline. Our divestiture of non-core telecom product lines negatively impacted revenue growth by approximately 2%. We also saw lower sales in general industrial applications in China and Europe, which were nearly offset by strength in emerging growth products. Revenue from materials processing applications decreased 6% year over year and revenue from other applications decreased 23% with strength in medical offset by weaker advanced application sales and the telecom divestiture.

During the quarter, we conducted a review of our Russian operations and recognized significant charges related to inventory, long-lived asset impairments and restructuring. These charges are a result of the lower level of activity we expect given the increasing limitation of sanctions.

GAAP gross margin was 18.2%, a decrease of 2,730 basis points year over year, due to $74 million of inventory write downs and other charges related to our Russian operations.

Excluding this inventory related charges, gross margin was approximately 40%. We provide adjusted results in the appendix on slide 11 of the presentation. Please note that adjusted results are non-GAAP items and while we believe they may be meaningful, these results should not be considered a substitute for GAAP measures. Gross margin was also negatively impacted by higher inventory provisions in the rest of the world, the stronger dollar, scrap, shipping costs and import duties. These were partially offset by increased absorption of manufacturing costs in the quarter as we continued to build our inventories of safety stock. We are working to offset the

impact of changes in the supply chain and manufacturing footprint on our gross margins by investing in automation and investing in locations with lower costs than Germany and the U.S. such as Poland or Italy. We remain committed to our long-term gross margin target of 45% to 50%.

Additionally, both revenue and gross margin were impacted by currency translation headwinds. If exchange rates relative to the U.S. dollar had been the same as one year ago, we would have expected revenue to be $25 million higher and gross profit to be $16 million higher.

Foreign currency transaction gains related to remeasuring foreign currency assets and liabilities to period-end exchange rates, benefited operating expenses by $7 million or $0.12 per diluted share. GAAP operating loss was $88 million and operating margin was negative 26.5%. The net loss in the quarter was $93 million, or $1.91 per diluted share. As mentioned above, we had a number of unusual items impacting our operating income and earnings per share in the quarter. There was a $74 million or $1.21 per diluted share impact from inventory related charges, $79 million or $1.30 per share impact from impairment of long-lived assets in Russia, and other restructuring charges of $10 million or $0.16 per diluted share. There was also a gain on sale of our corporate aircraft of $10 million or $0.16 per diluted share. Excluding these special items and the discrete tax impact of these items, adjusted diluted EPS was $1.08.

Moving to slide 5. Sales of high power CW lasers decreased 13% and represented approximately 39% of total revenue. Sales of ultra-high power lasers above 6 kW represented 47% of total high power CW laser sales. The decline was primarily due to lower demand in cutting applications in China and Europe, which was only partially offset by growth in welding applications across most major geographies. Pulsed lasers sales decreased 9% year over year as a result of lower demand in cutting and marking applications partially offset by strong sales into solar cell manufacturing. Systems sales increased 19% year over year driven by growth in

laser systems and higher sales of LightWELD. Medium power laser sales decreased 37% while QCW laser sales were down 21% year over year, negatively impacted by lower sales to consumer electronics and general industrial applications. Other product sales were nearly flat as growth in medical was offset by the divestiture of telecom business and lower revenue in advanced applications.

Looking at our performance by region on slide 6, revenue in North America decreased modestly by 3%, with growth in cutting, welding and medical applications offset by lower sales in non-laser systems, advanced applications as well as the telecom divestiture.

In Europe, sales decreased 21% as a result of lower demand across all major materials processing applications due to weaker macroeconomic conditions. Currency translation also negatively impacted sales in the region.

Revenue in China decreased 15% year over year as growth in welding, primarily for EV battery applications, was more than offset by continued softness in the cutting market, increased local competition, and currency headwinds. We estimate that Covid-related restrictions in China impacted fourth quarter revenue by approximately $7 million and bookings by approximately $14 million.

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 $42 million during the quarter and capital expenditures were $26 million in the quarter.

During the quarter, we repurchased shares for a total of $117 million. While continuing to maintain a strong balance sheet, we have returned $500 million of capital to shareholders with

our ongoing stock repurchases in 2022, which represents more than a half of our total share repurchases since 2016.

Our inventories declined due to the inventory write-down in Russia. With some improvements to the electronics supply chain, a decrease in required safety stock as we continue increase production of components in Europe and North America and a focus on improving our inventory management we plan to stabilize and then reduce the investment in inventory during 2023.

Our capex was $26 million in the quarter and $110 million for the full year. We expect 2023 capex to be in the range of $140 to $160 million. The expected expenditures in 2023 are at a higher rate than we expect longer term as we add buildings and equipment for production capacity expansion to increase production outside of Russia. Capex also includes investments in R&D, sales and service in North America, Germany and Asia.

Moving to outlook on slide 9, fourth quarter book-to-bill was slightly below 1. We saw continued softness in orders in Europe and China, primarily due to uncertain macroeconomic conditions which impacted demand in general industrial markets. Leading macroeconomic indicators for Europe, China and U.S. remain subdued, but conditions appear to be more stable in Europe and U.S. and there is an expectation of increasing activity in China later this year. Additionally, we are benefiting from growth opportunities created by major macro trends such as electric vehicle battery manufacturing and renewable energy. We are seeing continued strong orders in e-mobility and welding applications, which are not being impacted by the economic uncertainty. Furthermore, LightWELD and medical products continue to ramp up, presenting future growth opportunities for IPG.

For the first quarter of 2023, IPG expects revenue of $310 to $340 million. The Company expects the first quarter tax rate to be approximately 26%. IPG anticipates delivering earnings per diluted share in the range of $0.90 to $1.20, with approximately 48 million diluted common shares outstanding. We continue to expect currency headwinds and estimate that the first quarter revenue guidance is reduced by about $9 million due to the strength of the U.S. dollar in the current quarter as compared to the first quarter 2022.

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. As usual, we will be participating in a number of investor events this quarter and are looking forward to speaking with you soon. Have a great day everyone.