

IPG Photonics Corporation

Second Quarter 2018 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' second quarter 2018 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-K for the year ended December 31, 2017 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, July 31, 2018. 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.

IPG delivered another quarter of record revenue, net income and bookings driven by the rapid adoption of our high power products. During the second quarter, we shipped more high-power units and sold more optical power than we did in an entire year just three years ago. We also made important strides in our newest product areas. We achieved strong growth in our new ultraviolet, green and ultrafast pulsed laser products. We also delivered a record quarter in our systems and beam delivery business, evidence we are becoming a more complete solutions provider within the automotive, aerospace, railway, pipeline, entertainment and medical device industries.

While the second quarter was strong, demand softened in Europe and China at the end of the quarter resulting in more modest year over year growth in orders. We believe this trend is primarily driven by macroeconomic and geopolitical factors rather than competitive dynamics. We are seeing strong order activity in North America and some smaller regions. We remain the market leader in fiber laser technology and expect to maintain, if not expand our market share this year. IPG pioneered the development of hundreds of key technologies over the last two decades that enable our technology and cost advantages within the laser industry. There is no company that can deliver high power laser solutions at our scale, quality, cost and lead time.

Our high power fiber lasers enable faster processing speeds, along with superior productivity and flexibility. These benefits only increase at higher powers. As a result, we are benefiting from

rapid market acceptance of our ultra high power fiber laser technology at six kilowatts and above. Ultra high power laser sales increased more than 50% year over year and are now more than 40% of total high power product sales. We continue to see our largest OEM customers migrating to higher power fiber laser cutting solutions at 8 and 10 kilowatts. In addition, leading-edge OEMs are now purchasing our unique fiber lasers at 12 and 15 kilowatts, which has no laser competition at all. These ultra-high power lasers continue to demonstrate faster cutting speeds and improved end user productivity.

At the lower end of the cutting systems market, Q2 sales of our high-power, rack-mounted fiber lasers increased by nearly 50% year over year, with an even higher growth in unit volumes. The market for lower end laser cutting systems in China has been expanding rapidly, driven by the superior productivity and flexibility of fiber laser cutting systems over non-laser technologies such as punch-presses that use inflexible dies that take weeks to build and wear out over time. Although the market for lasers in low cost cutting systems remains a competitive one, our rack-mounted products have enabled us to expand the market for laser technology while accelerating growth in this important product category.

We are seeing strong traction in our newest pulsed laser products. Sales of green pulsed lasers used as an ablation tool for improving solar cell efficiency more than doubled versus the year-ago period. In only our second quarter selling ultraviolet lasers, we achieved our first million-dollar quarter for this product, driven by an application in consumer electronics. This product family expands our addressable market for marking and engraving of non-metals and for material ablation. Within our new family of ultrafast pulsed lasers, revenue increased double

digits sequentially as we continue to target opportunities in the micro materials processing, scientific, and medical arenas.

As we expand our product capabilities within optical accessories, beam delivery products, and systems, we are becoming a more complete solution provider to our customers. Sales of beam delivery accessories, including high power welding and cutting heads, scanners, collimators, beam switches and process fibers, increased by 50% during the second quarter. Systems sales grew at an even faster rate, nearly doubling on a year-over-year basis as we continue to target solutions opportunities in the automotive, aerospace, railway, pipeline, and medical device industries.

I remain confident in IPG's ability to grow faster than the markets we serve. We are still in the early stages of fiber laser penetration against traditional tools and process technologies that are inflexible, less precise, and less powerful by comparison. IPG's growth is enabled by the superior productivity, reliability, and cost of ownership of our products over competing laser and non-laser solutions. Moreover, we continue to advance in new product areas that meaningfully expand our addressable market in the micro materials processing, medical, defense, scientific, and projection and display industries. Despite some headwinds in our business over the near-term, IPG has multiple potential growth drivers for the long-term, as we 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 Tim.

Tim Mammen:

Thank you Valentin and good morning everyone. I will review the key financial highlights of the quarter. Revenue in the second quarter grew 12% to \$414 million. Foreign exchange headwinds during the quarter relative to sales assumed in our Q2 guidance reduced revenue by \$8.4 million. Without this impact, Q2 revenue would have been above the midpoint of our guidance range. Revenue from materials processing applications increased 11% year over year, driven by lasers sold for cutting and 3D printing applications. Revenue from other applications increased 33% year over year.

By region, second quarter revenue in China increased 10% year over year and represented approximately 49% of total. Sales of high power CW lasers for cutting applications drove the majority of the revenue increase in China versus the year-ago period. Welding sales in the region declined on a year over year basis. We saw an expected reduction in demand related to the consumer electronics investment cycle as well as continued softness in high power welding related to automotive and electric vehicle battery welding in the region.

In Europe, revenue increased 18% year over year, driven by strength in medium power lasers for 3D printing applications, high power lasers for cutting applications, and high power pulsed laser sales for cleaning and stripping applications. Based on the record level of laser shipments into 3D printing customers during the first half 2018, we expect to see a period of digestion through the end of the year, with second half laser shipments into 3D printing customers down versus the first half of the year. In North America, second quarter revenue growth increased by

23% year over year driven by strength in cutting and welding applications. Sales in Japan decreased 2% year over year with a continued rebound in cutting offset by declines in welding and marking and engraving. We continue to target compelling expansion opportunities in cutting, welding and other applications areas that we believe will drive improved performance in the region.

Turning to performance by product, high power laser sales increased 20% year over year to \$266 million in the second quarter and represented more than 64% of total revenue. Fiber lasers at 6 kilowatts and above grew at an even faster rate and now account for more than 40% of all high power laser sales. Sales of our 1, 1.5, and 2 kilowatt rack-mounted fiber lasers increased by nearly 50% year over year, with even higher growth in unit volumes, driven by rapid growth in lower end laser cutting systems in China. Pulsed lasers sales increased 1% year over year, with rapid growth in green, ultraviolet, ultrafast, and our highest-power pulsed products offset by lower sales of lower-power pulsed products. Medium power laser sales decreased 7% as strength in 3D printing and welding applications was more than offset by a decline in cutting attributable to the shift by OEMs to kilowatt-scale lasers. Other product sales increased 27% year over year due to the strong sales growth in systems and beam delivery accessories that Valentin noted earlier. Finally, QCW sales of \$20 million declined 32% year over year due to the expected reduction in demand related to the consumer electronics investment cycle.

Second quarter gross margin of 56.8% was up 90 basis points from Q2 2017 and above our guidance range of 50% to 55%. We were able to more than offset declines in average selling prices with improved manufacturing efficiency, cost reductions, and favorable product mix.

Second quarter operating income was \$162 million, or 39.3% of sales, up 110 basis points from Q2 2017. Excluding a foreign exchange loss of \$2 million, operating margin was 39.8%.

Operating expenses as a percentage of sales increased 130 basis points year over year as we continue to make necessary investments in sales, engineering and administrative talent, as well as in IT systems. On a sequential basis, operating expenses declined 170 basis points as a percentage of sales.

Q2 net income was \$122 million and earnings per diluted share were \$2.21. Foreign exchange losses reduced EPS by \$0.03. If exchange rates relative to the US Dollar had been the same as one year ago, we would have expected revenue to be \$23 million lower and gross profit to be \$15 million lower. The effective tax rate in the quarter was 26%, which benefited from the lower effective tax rate for income earned in the United States due to enactment of the Tax Cuts and Jobs Act and an increase in excess tax benefits related to equity compensation, which were partially offset by provisions for uncertain tax positions and other matters.

We ended the quarter with cash, cash equivalents, and short-term investments of \$1.13 billion and total debt of \$47 million. During the quarter we repatriated \$406 million in cash from Europe into the US. We expect to repatriate an additional \$117 million from Europe into the US in the third quarter. As a result, we expect our interest income to increase by more than \$3 million per quarter.

Cash provided by operations during the quarter was \$109 million, up 32% from Q2 2017. Capital expenditures were \$57 million, up 160% year over year. We continue to invest in new facilities and equipment to meet demand for our products over the next several years. Second quarter

capex includes \$26 million to acquire a manufacturing facility adjacent to our Oxford, Massachusetts operations.

We repurchased 132 thousand shares for \$31 million, completing the initial \$100 million authorization of our antidilutive repurchase program. Since the program began in July 2016, we repurchased 593 thousand total shares for \$100 million at an average price of \$168. The Board of Directors has authorized a new \$125 million anti-dilutive stock repurchase program. Under this program IPG management is authorized to repurchase shares of common stock in an amount not to exceed the greater of (1) the number of shares issued to employees and directors from January 1, 2018 through March 31, 2019 and (2) \$125 million, exclusive of any fees, commissions or other expenses. As a reminder, the share repurchase program authorization does not obligate the Company to repurchase any dollar amount or number of its shares, and repurchases may be commenced or suspended from time to time without prior notice.

Turning to guidance, book-to-bill was at 1.0 for the quarter. While orders grew slightly on a year over year basis, order flow was below our target as demand softened in Europe and China at the end of the quarter. This more modest year over year growth in orders has persisted through July, and we believe is primarily driven by macroeconomic and geopolitical factors rather than competitive dynamics. In addition, we do not expect to see a material pickup in welding during the third quarter as projects related to electric vehicle battery investment may only materialize in Q4, and the consumer electronics investment cycle remains a headwind to growth. Finally, foreign exchange tailwinds that have benefited revenue for the last four quarters have reversed with the depreciation of the Chinese Yuan and Euro. While we are encouraged by the strength in

new products and select regions, including North America, this growth will only partially offset the more modest outlook in China and Europe.

Based on these factors, for the third quarter 2018 we expect revenue of \$360 million to \$390 million. We expect our third quarter tax rate to be approximately 26% excluding effects relating to equity grants. We anticipate delivering earnings per diluted share in the range of \$1.80 to \$2.05.

As compared to just a few months ago, the current global macroeconomic trade and geopolitical environment is more uncertain and could remain so. In addition, we expect foreign exchange to be more of a headwind, particularly with the depreciation of the Chinese Yuan over the last month. As such, we believe full year revenue growth for 2018 will be in the range of 7% to 9%.

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, 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.

Valentin Gapontsev:

Thank you for joining us this morning. We look forward to speaking with you on next quarter's call. Have a great day.