IPG Photonics Corporation

Fourth Quarter 2018 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' fourth 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, February 12, 2019. 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.

As expected, the fourth quarter was challenging. The macroeconomic climate weakened in our largest markets, reducing demand for our laser products. Despite these challenges, we were able to deliver results in line with the outlook we provided a quarter ago. More importantly, we have made meaningful strides in key new product areas, and undertaken strategic acquisitions that help us capitalize on the long-term growth opportunities for our laser solutions. We believe our progress delivering on new growth opportunities: (1) reinforces our industry leadership in fiber laser technology; (2) strengthens our relationships with leading-edge customers; and (3) enables the next-generation of product creation.

In China, we saw further weakening of the demand environment in Q4. Higher tariffs have made minimal effect on our production costs thanks to our diverse global manufacturing footprint and vertically integrated manufacturing. However, the US-China trade war has heightened end customer fear and uncertainty. Continued investment spending on industrial land suggests that Chinese manufacturers likely remain committed to their long-term growth plans. In addition, the Chinese Government has enacted targeted stimulus to address the macro uncertainty and trade war fears of private enterprises. These factors suggest we could see demand begin to stabilize.

Near-term, we have seen signs of stabilization in our European business. Unfortunately the drop in Eurozone manufacturing PMI from more than 60 a year ago to slightly above 50 today drove a decline in our European business during the second half of 2018. The Eurozone is also affected by softer China demand. There is less certainty among our European customers regarding a pickup in demand, but overall trends do not appear to have worsened. Regardless of macroeconomic climate, we remain confident in the longer-term secular growth of fiber laser technology over other lasers and non-laser tools, as well as the continued shift toward higher power solutions in our largest markets.

We believe there is no company that can deliver high power laser solutions at our quality, scale, cost and lead time. While competitors are announcing new products with output power of up to 10 kilowatts, we believe our advanced technology, scale and cost advantage over the competition will enable us to continue to win in this market. We are seeing strong customer interest for our new CW lasers with QCW mode capability that provide peak power up to two times average power, increasing piercing speed, improving cut quality, and delivering cleaner, more controlled drilling of thicker materials. This unique capability is enabled by IPG's QCW diode designs that provide very high peak power for short duty cycles. Customers are also evaluating our adjustable mode beam lasers, which permit reliable adjustment of output beam mode to process a wider range of material thicknesses without the use of external optics and without stressing the optical fiber, which we believe can be an issue for competing technologies. When combined with the ongoing improvements we make each year to the power, electrical efficiency, compactness, reliability, and productivity of our fiber laser portfolio, we expect to continue to drive share gains from traditional process technologies and maintain our competitive lead in the high end of the industrial laser market.

In 2018 we made excellent progress in new growth areas helping to diversify our business. Sales of new pulsed lasers, systems, communications products, and advanced applications increased 36% in 2018 to approximately 15% of total revenue and 20% of total revenue in the fourth quarter.

We demonstrated solid traction selling new pulsed laser products, which increased 30% in 2018. These new products include: (1) our high power nanosecond pulsed lasers for marking, ablation and cleaning; (2) our green pulsed lasers for solar cell ablation; (3) ultraviolet lasers for nonmetal marking and material ablation; and (4) our family of picosecond and femtosecond ultrafast pulsed lasers for micro processing applications. In addition to sales of new lasers, we sold a record number of beam delivery accessories and complete laser systems, evidence we are becoming a more complete solutions provider within the automotive, aerospace, railway, pipeline, entertainment, medical device, communications and large screen projector systems industries.

In 2018, systems sales of nearly $60 million increased 47% year over year driven by growth in macro and micro systems and early revenue from our super high lumen digital cinema system. In December, we closed the acquisition of Genesis Systems Group, a qualified robotic systems integrator for more than 300 blue-chip customers, most of which are in the US, helping to diversify our geographic exposure. The acquisition of Genesis is an important step for IPG's evolution to becoming a more complete provider of welding solutions and strategic partner to end customers. We plan to leverage Genesis' unique expertise in robotic systems integration to accelerate laser processing within the transportation, aerospace and industrial end markets. Genesis also provides a route to market for IPG's advanced laser welding and laser cleaning solutions.

In communications, revenue increased 7% year over year in 2018 driven by double digit growth in transceiver products. Since the acquisition of Menara Networks in 2016, we have been investing to leverage their proprietary high speed ICs, transceiver design and integration capabilities to introduce new pluggable transceiver products into this market. These products address growing bandwidth demand from data center and telecom customers, and capitalize on the trends toward merchant silicon and coherent, pluggable optics. The recently announced acquisition of Padtec's Submarine Networks Division will leverage our leading-edge optical amplifier and WDM systems capability to address the growing number of undersea cable network deployments by next-gen Internet and data center companies. Although communications is a small business for us today, we are making strategic investments that we believe will grow this business to be much more meaningful over time.

In advanced applications, we saw increasing acceptance of our single mode fiber lasers, narrow-line amplifiers and high power semiconductor diodes. Combining these new product opportunities with progress we are making in medical and dental lasers, instrumentation, semiconductors, electronics, and scientific applications, IPG is unlocking multiple growth drivers that significantly expand our addressable market and diversify our end market exposure.

Over the last decade, our fiber laser technology has captured a majority of the market share for laser-based metal processing. Much of the recent growth has come from China. The share gains achieved in metal processing mean we are now more susceptible to spending cycles on industrial capital equipment. However, we continue to invest in new fiber laser solutions that address diverse end markets including electronics, medical, scientific, defense, entertainment, and communications. In 2018 alone, we spent $123 million in research and development and $109 million on acquisitions to enhance our solutions portfolio and open up new markets. We expect to grow faster in these new product areas, diversifying our end market exposure and enabling IPG to target a double digit revenue growth rate.

Although we start the year with a more challenging macroeconomic backdrop, we remain optimistic about IPG's long-term growth prospects given our superior technology platform and vertically-integrated production model. By leveraging these advantages, we believe growth in our core industrial markets will be driven by higher power solutions and the superior performance, productivity, reliability, and cost of ownership of our products over competing solutions. I remain confident in IPG's ability to grow over the long-term and to 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. Revenue in the fourth quarter declined 9% to $330 million. The acquisition of Genesis, which closed in early December, contributed $8.5 million revenue during the quarter. Foreign exchange headwinds during the quarter relative to sales assumed in our Q4 guidance reduced revenue by $2 million. Revenue from materials processing applications decreased 9% year over year and revenue from other applications increased 5% driven by growth in communications, medical, and government applications. For the full year materials processing revenue increased 3% as strength in the first half was offset by a slowdown in the second half of the year.

By region, fourth quarter revenue in China represented approximately 36% of the total and decreased by 19% year over year . Strong sales growth into electric vehicle battery applications was more than offset by declines in cutting and micro welding for consumer electronics. Our cutting business remains affected by the current macroeconomic climate in China. During the first quarter, we expect to ship the remaining lasers related to the record Q3 order for battery processing applications. Beyond this order we do not have near-term visibility into additional orders for this application, but continue to expect a strong contribution from electric vehicle applications this year and over the medium to longer-term. As for micro welding in consumer electronics, recent data points from the smartphone supply chain would now suggest we are unlikely to see this business rebound in 2019.

In Europe, revenue decreased 12% year over year primarily relating to softness in cutting, additive manufacturing and welding due to the weaker macroeconomic climate in the region. However, European sales increased 8% on a sequential basis, suggesting that we may have reached a bottom in the current downturn in this business. In North America, revenue increased

32% year over year and 14% year over year excluding Genesis, driven by strength in cutting, communications and government applications. Sales in Japan increased 4% year over year with a continued rebound in cutting and welding. Sales in Korea increased 9% year over year and revenue in Turkey decreased approximately 40% given the recent economic turmoil in the country. For the full year 2018, sales in China and Europe increased 1%, with growth in the first half of the year offset by declines in the second half, while sales North America increased 22% and other regions increased 11%.

Turning to performance by product, high power laser sales decreased 20% year over year to $186 million in the quarter and represented 56% of total revenue. Reduced sales of lasers for cutting and additive manufacturing were partially offset by strength in welding sales, primarily related to electric vehicle battery production. Fiber lasers at 10 kilowatts of power or more increased nearly 50% in the fourth quarter.

For the full year, high power laser sales increased 5% year over year. Total optical power sold increased by more than 10% and was up more than 40% for continuous wave lasers at six kilowatts or greater. These ultra high power lasers were more than 40% of our high power sales in 2018, driven by the productivity gains enabled by these lasers within cutting, welding, sintering and cladding applications. Particularly encouraging was our success in driving sales of higher power CW lasers within cutting applications, where sales of 12 and 15 kilowatt lasers increased six-fold, and we introduced the world's most compact 20 kilowatt cutting laser.

In the low cost cutting market served by lasers at 1-4 kilowatts of power, the competitive landscape remains intense, particularly in China. Pricing pressures in this business are being exacerbated by softening demand trends. We continue to see good success winning business from the competition with our introduction of new ultra compact products at these power levels that possess higher reliability and greater power efficiency than the competition, and which benefit from IPG's much broader support and service footprint. The revenue impact from these gains has been limited by macroeconomic and geopolitical headwinds, but these efforts are yielding positive results. In addition, our unique QCW-CW feature is, we believe, going to be fundamentally important in the 1-6 kilowatt power range where we are seeing higher levels of competition.

Pulsed lasers sales increased 33% year over year, with rapid growth in green, high power, ultraviolet and ultrafast pulsed lasers offset by reduced sales of lower power pulsed products. For the full year, sales of pulsed lasers increased 9%, with higher power, shorter wavelength and shorter pulse duration lasers representing nearly 50% of total pulsed lasers sales. Sales of QCW lasers decreased 12% year over year in Q4 and 24% year over year for the full year due to the weaker consumer electronics investment cycle.

Medium power laser sales decreased 29% year over year in Q4 and 19% year over year in 2018 due to the aforementioned transition to kilowatt scale lasers in cutting and the weak additive manufacturing demand we have called out. Systems sales increased 42% year over year in Q4 and 47% year over year in 2018 driven by growth in macro systems for materials processing, micro systems, initial sales of our cinema projection system and the acquisition of Genesis. I would note that in our financial data workbook we have made several changes to the revenue breakdown by product that reflect a shift in the relative importance of certain product lines over time.

Gross margin of 50.5% declined 730 basis points from Q4 2017 and was slightly above the low end of our guidance range of 50% to 55%. The decline in gross margin was mainly attributable to the lower revenue in the fourth quarter of 2018 versus the year ago period resulting in less favorable absorption of manufacturing costs. Although we did not see the same level of pricing pressure in the low cost cutting business during Q4 as we experienced in Q3, a full quarter's impact from Q3 price reductions, when combined with lower absorption of manufacturing costs, served to reduce our Q4 gross margin. The acquisition of Genesis reduced fourth quarter gross margin by approximately 60 basis points as well.

Fourth quarter operating income was $96 million, or 29.1% of sales, down 1200 basis points from Q4 2017. Excluding a foreign exchange gain of $5 million, operating margin was 27.7%. Operating expenses as a percentage of sales increased 570 basis points year over year due to the lower revenue level. The acquisition of Genesis increased operating expenses by approximately $2 million and reduced operating margin by 50 basis points. In addition, we made necessary investments in sales, engineering and administrative talent, as well as IT systems.

Net income was $76 million and earnings per diluted share were $1.40. Foreign exchange gains increased EPS by $0.07. If exchange rates relative to the US Dollar had been the same as one year ago, we would have expected revenue to be $10 million higher and gross profit to be $6 million higher. The effective tax rate in the quarter was 25%, which benefited from certain discrete tax items.

We ended the quarter with cash, cash equivalents, and short-term investments of $1.04 billion and total debt of $45 million. US cash and investments represent approximately 70% of total. Cash provided by operations was strong at $113 million during the quarter and was $393 million for the year. Capital expenditures were $27 million during quarter and were $160 million in 2018, up 27% year over year. We continue to invest in new facilities and equipment to meet demand for our products over the next several years. We expect capital expenditures to be $145 to $165 million in 2019.

In Q4 we repurchased 466 thousand shares for $64 million, completing the $125 million repurchase authorization we announced last August. For the year we spent $176 million repurchasing over 1 million shares and have now offset all dilution from equity compensation and employee stock purchases plans since our repurchase program started in July 2016. 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 lesser of (1) the number of shares issued to employees and directors under the Company's various employee and director equity compensation and employee stock purchase plans from January 1, 2019 through December 31, 2020 and (2) $125 million in total, 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.

Our year-end backlog decreased 4% to $712 million. Orders with firm shipment dates increased 4% to $339 million. Frame agreements, which are non-binding indications of customer pricing and volume levels, decreased 11% to $374 million. With nearly 50% of frame agreements related to customers in China, we believe the decline in frame agreements reflects the current demand weakness in the region. Backlog excluding the acquisition of Genesis was $673 million, decreasing 10% year over year while shippable orders excluding Genesis were $299 million, decreasing 8% year over year. Fourth quarter book-to-bill was below 1.0 but in line with normal seasonality.

Turning to guidance, while the global macroeconomic and geopolitical challenges affecting the sector and our business have persisted into 2019, it is important to note we have seen some encouraging signs over the last two months. There has been a modest pickup in order activity since late December, and we are more encouraged by the overall demand environment than we were three months ago. Our conviction around improving market conditions will only be fully validated if these trends continue for the remainder of the first quarter and into the second quarter. We do expect pricing headwinds related to more aggressive competition in China to continue, exacerbating this challenging demand environment. However, we are reinforcing our competitive lead in our core metal processing markets, retaining our established relationships with large customers and winning new business with emerging OEM customers. Moreover, we are making competitive strides in new products and applications that significantly expand our addressable market and diversify our end market exposure.

Based on these factors, for the first quarter 2019 we expect revenue of $290 million to $320 million. We expect our tax rate to be approximately 25% excluding effects relating to equity grants. We anticipate delivering earnings per diluted share in the range of $1.00 to $1.20. We expect the acquisition of Genesis to reduce first quarter gross margin by approximately 200 basis points as the systems business generally has lower gross margins.

Although conversations with our OEM customers in China suggest cautious optimism regarding a mid-year pickup in demand driven by government stimulus and continued infrastructure investment, we do not have clear visibility into full year OEM order plans at this time. As such, we do not believe it is appropriate to provide full year revenue guidance until this visibility improves. In general, we would expect year-over-year declines in revenue to persist in the first and second quarter of 2019 due to more challenging comparisons, followed by improving trends in the back half of 2019 driven by potential market recovery and strength in new products and solutions.

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.