IPG Photonics Corporation
First Quarter 2019 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' first quarter 2019 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, 2018 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, April 30, 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:

We were pleased to deliver first quarter results in line with our guidance given the challenging macroeconomic, geopolitical and competitive backdrop. During the quarter business trends improved in China driving sequential growth in orders. More importantly, we have met competitive challenges head on, substantially reducing component and manufacturing costs. We have also introduced unmatched product features that improve processing speed, flexibility and quality for our customers. IPG always seeks to gain advantage during times of market stress. If properly executed, these challenging times can be a catalyst for R&D investment that results in a stronger competitive position on which excess returns can be earned.

We remain the clear market leader in fiber lasers with hundreds of megawatts of installed capacity. In the first quarter, we shipped more than 11 megawatts of total optical power, up nearly 10% year over year. High power megawatts increased even more nearly 15% year over year. Although we have seen aggressive pricing among China-based competition for 1 to 4 kilowatt lasers serving the low cost cutting market, we increased sales of our rack-mounted lasers sequentially, with even stronger unit growth. The pricing environment has affected the dollar value of units serving this market. However, our ability to rapidly reduce costs has limited the gross margin impact to just 200 basis points year over year. Last year we reduced the cost of diodes and other components by more than 15% and have started the mass production of new diodes in Q1. This year we have visibility into further cost reductions and product enhancements that we believe extend our competitive lead.

In the last few quarters we have developed and recently started shipping new 2 and 4 kilowatt QCW-mode lasers with double peak power capability. These lasers enhance our competitive position in the cutting market. They provide peak power up to two times average power, increasing piercing speed, improving cut quality, delivering cleaner, more controlled drilling of thicker materials while reducing scrap. These lasers provide a big advantage over our China-based competition. At ultra high power, multiple IPG customers will shortly be launching their first 20 kilowatt laser cutting systems, raising the bar for speed and flexibility in processing thicker metals vs. non-laser technologies. In addition, we see compelling customer interest in our new generation lasers with adjustable mode beam capability that permits reliable adjustment of the output beam to process a wider range of material thicknesses for cutting applications, while reducing spatter and improving quality in welding applications.

We also made solid progress in our newest product areas outside metal processing. Sales of green pulsed lasers used to improve solar cell efficiency more than doubled year over year. We also delivered strong growth in red, blue and other visible lasers. We increased sales of our ultrafast pulsed lasers nearly three times compared with the prior year and are actively working on more than 50 new projects for these lasers across a wide range of applications. Systems sales increased more than 200%, and the acquisition of Genesis allows IPG to accelerate laser processing within the transportation, agriculture, aerospace and industrial end markets. Sales of beam delivery accessories increased more than 70% year over year. We increased sales of our laser-based cinema projection system more than 150% year over year as our solution is being adopted at three of the leading providers of cinema projection technology. We also have visibility into strong growth in medical laser solutions this year. Collectively, sales of newer laser products and systems into emerging applications grew at a double digit rate in the first quarter and were 15% of total revenue.

We continue to demonstrate meaningful traction in ultra high power fiber lasers while investing in new products and applications. We believe this progress substantially expands our addressable market and opens up opportunities that will drive the company's growth for many years. Our mission is to make IPG's fiber laser technology the tool of choice in mass production for many years ahead. I am confident in our ability to execute on this mission and deliver superior returns.

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

Tim Mammen:

Thank you Valentin and good morning everyone. Revenue in the first quarter declined 12% year over year to $315 million. Revenue from materials processing applications decreased 11% year over year and revenue from other applications decreased 32% due to the timing of orders in our advanced applications and communications businesses.

By region, first quarter revenue in China decreased 24% year over year and represented approximately 36% of the total. Macro-driven softness in cutting and marking applications was partially offset by growth in macro welding. Within China, sales of ultra high power CW lasers grew by a double digit percentage, but were more than offset by declining sales of lasers for lower power applications. In Europe, revenue decreased 24% year over year primarily due to softness in cutting and additive manufacturing, partially offset by growth in welding. In Europe total sales of $88 million were consistent with the Q3'18 level, which supports our previous assertion that revenue in the region appears to have stabilized. However, continued macroeconomic softness in the region, as evidenced by the decline in Eurozone manufacturing PMI, makes predicting an eventual rebound in Europe more challenging.

In North America, revenue increased 65% year over year driven by the acquisition of Genesis. Excluding Genesis, sales in North America increased 1% year over year with slight declines in cutting, welding, and marking offset by strength in other products and applications. Sales in Japan decreased 20% year over year on softness in marking, welding and cutting. However, strong bookings in the region suggest improved performance in Japan during the second quarter. Sales in Korea increased 4%, and revenue in Turkey decreased 36% year over year but improved sequentially.

Turning to performance by product, high power CW laser sales decreased 22% year over year and represented approximately 57% of total revenue. Reduced sales of high power CW lasers for cutting and additive manufacturing were partially offset by strength in welding applications. Sales of ultra high power fiber lasers at 6 kilowatts or greater accounted for nearly 50% of all high power laser sales, driven by rapid adoption in cutting applications. Sales of lasers at 10 kilowatts or greater increased more than 40% year over year while sales of other high power lasers declined year over year due to the weaker demand environment in China and Europe and more aggressive price reductions on select products.

Pulsed lasers sales decreased 18% year over year, with rapid growth in green and ultrafast pulsed lasers offset by reduced sales of other pulsed products. Medium and low power laser sales decreased 39% on softness in additive manufacturing and the transition to kilowatt-scale lasers in cutting. QCW sales declined 13% year over year but increased 17% on a sequential basis as lower sales into consumer electronics applications was partially offset by increased sales of higher power QCW lasers into other applications. Systems sales increased 245% year over year due to the acquisition of Genesis. Excluding Genesis, systems sales increased nearly 20% year over year driven by growth in macrosystems for welding, drilling, and ablation applications, along with initial acceptance of our laser-based cinema projection system at several leading providers of cinema projection technology. Other product sales increased 6% year over year driven by growth in beam delivery accessories and service revenue.

Gross margin of 47.3% declined 920 basis points from the first quarter 2018. Compared with the year-ago period, less favorable absorption of manufacturing expenses reduced gross margin by nearly 500 basis points. Lower than expected absorption of manufacturing expenses and a higher inventory provision resulted in gross margin coming in slightly below the low end of our expected Q1 range. In addition, acquisitions reduced gross margin by more than 200 basis points, and lower product pricing and foreign exchange headwinds reduced gross margin by a further 200 basis points approximately. Holding other factors constant, we believe that recovery in our business to $380 million in quarterly sales would enable us to get close to the mid-point of our long-term gross margin guidance of 50% to 55%.

First quarter operating income was $68 million, or 21.7% of sales, down 1750 basis points from the first quarter 2018. Excluding a foreign exchange loss of $2 million, operating margin was 22.2%. Excluding foreign exchange, operating expenses as a percentage of sales increased 630 basis points year over year due to: lower revenue; investments in engineers, salespeople and IT systems; higher R&D material costs; and higher than normal legal expenses.

Net income was $55 million and earnings per diluted share were $1.02. Slightly lower than expected absorption of fixed manufacturing costs and a higher inventory provision reduced EPS by $0.04 relative to guidance. In addition, higher R&D material expenses, nonrecurring legal costs and foreign exchange losses reduced EPS by $0.04. If exchange rates relative to the US Dollar had been the same as one year ago, we would have expected revenue to be $15 million higher and gross profit to be $8 million higher. The effective tax rate in the quarter was 24%, which included certain discrete tax items.

We ended the quarter with cash, cash equivalents, and short-term investments of $1.03 billion and total debt of $44 million. Cash provided by operations was $46 million during the quarter. Operating cash flow was reduced by cash tax payments that totaled more than $50 million relative to a Q1 tax provision of $17 million. These payments were primarily related to the timing of cash taxes paid in Germany with the filing of our 2017 tax return in Q4 2018. Capital expenditures were $33 million, which included approximately $21 million for the purchase of a new facility in Massachusetts, as we continue to invest in new plants and equipment to meet demand for our products over the next several years.

Turning to guidance, we have seen further signs of improving business conditions in China, our largest region, with sequential growth in orders and good momentum through the first three weeks of the second quarter. Our first quarter book-to-bill ratio was above one, in line with normal seasonality, albeit off a lower base given the weaker macroeconomic climate. If this momentum in China is maintained, it should continue to drive better performance. Performance in Europe is generally stable but down from peak levels, reflecting reported economic trends in the region. We expect pricing headwinds related to competition in China to continue. We believe our innovative new products, accessories and complete solutions, which provide customers with a superior value proposition, both cement and enhance our market leadership position.

Based on these factors, for the second quarter 2019 we expect revenue of $340 million to $370 million. We expect our second quarter tax rate to be approximately 25%. We anticipate delivering earnings per diluted share in the range of $1.25 to $1.55.

Commentary from our largest machine tool OEM customers continues to improve, but we do not yet have clear visibility into their full year order plans. As such, we do not believe it is appropriate to provide full year revenue guidance at this time. As a reminder, we would expect year-over-year trends to improve in the back half of 2019 driven by 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.

James Hillier:

Thank you for joining us this morning and for your continued interest in IPG. We look forward to speaking with you over the coming weeks and on next quarter's call. Have a great day everyone.