IPG Photonics Corporation
Fourth Quarter 2019 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' fourth 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, Chief Operating Officer Dr. Eugene Scherbakov 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-Q for the quarter ended June 30, 2019 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 13, 2020. 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. We delivered fourth quarter revenue slightly above our guidance range on strength in the US market and new products. The global macroeconomic backdrop and the competitive landscape in China both remain challenging. However, we are responding with product cost reductions and differentiated new features and accessories for our core products. Furthermore, we are leveraging one of the largest R&D investments in the laser industry to launch leading edge laser products and systems for new markets. These new solutions, which represent about one-fifth of total sales, enhance our growth and margin profile and provide greater geographic and end market diversification.

Although weaker macroeconomic trends have reduced demand for our core products in the near-term, we introduced new lasers and new features that enhance productivity and flexibility for the industry. In 2019 we shipped a record number of high power lasers, increasing laser units at 1 kilowatt or greater by 23% or 14,500 total including nearly 60% growth in rack-mounted YLR units at 1-4 kilowatts. In addition, we increased sales of lasers at 10 kilowatts or greater by more than 25%. However this impressive growth did not compensate for lower pricing in China, which affected total high power laser revenue. Multiple IPG customers are launching new cutting systems using our 12 kilowatt lasers, and we increased sales of 20 kilowatt lasers for cutting applications 8-fold. Many of these are sold with our new ultra high power cutting heads. In addition, we sold our first lasers with high peak power and adjustable mode beam capability. HPP products deliver peak energy twice the average power of the laser, increasing cutting speed and quality while reducing scrap through closer nesting of parts. Our new AMB lasers permit the broadest range of beam tunability, enabling spatterless welding and enhancing the speed of electric vehicle battery production. When combined with our unique high power pulsed lasers for foil cutting and ultra high power CW lasers for welding, we see significant opportunities in the electric vehicle battery market this year.

Our fiber lasers increase customer return on investment by delivering the industry's highest power, wall-plug efficiency and reliability, along with industry-leading beam quality. Competitors' lasers often struggle to maintain power even after only several hundred hours of operation. IPG lasers deliver peace of mind and lower lifetime costs, while enhancing end user productivity. IPG also offers the highest brightness through 50 micron core diameter fiber, providing our customers with more than 70% higher productivity in cutting thin metals versus a competing laser in 100 micron fiber.

Augmenting our laser solutions with high power optical heads is a key differentiator versus our laser competitors. In 2019 we delivered record sales of optical heads and other beam delivery accessories, growing sales of these products by 10%. We also shipped our first volume orders of LDD process monitoring systems, our patented real-time weld monitoring solution. LDD enables greater use of laser-based welding in automated production environments, and we are pursuing multiple million dollar plus opportunities with this technology and associated laser product sales.

We sold a record number of systems for materials processing in 2019 with revenue increasing 33% excluding Genesis, which we acquired in December 2018. Standard and custom systems for vehicle and battery production, medical device manufacturing, pipe welding, cleaning and inspection applications drove systems growth. We plan to leverage Genesis' unique expertise in robotic systems integration to accelerate laser processing within the transportation, aerospace and industrial end markets.

Product innovation remains core to IPG's success. In 2019 new product sales were 19% of total revenue and 24% in the fourth quarter alone. Sales of green pulsed lasers used to improve solar cell efficiency increased by more than 60% in 2019. Sales of ultrafast pulsed lasers increased more than 80% year over year off a small base, with more than 50 new projects for these lasers across a wide range of applications processing glass, ceramics, circuit boards, OLED film, batteries and solar cells. As we enhance the pulse energy and expand the portfolio of new green, ultraviolet and ultrafast pulsed lasers, we expect revenue for these products to grow rapidly over the coming years and become a more meaningful percentage of total sales.

Sales of medical lasers increased 80% in 2019 as our thulium laser solution received approvals in China and the US. We expect sales into urology and other soft tissue applications to ramp over the coming years off a low base. Our medical laser business model includes consumable fibers, a continuing revenue stream that benefits as the number of installed systems increases. Sales of our RGB luminaire laser system for cinema applications increased more than 100% in 2019. We continue to invest in transformative new products within new application areas as well, including new medical treatments, mid-infrared lasers for spectroscopy, inspection and sensing applications, and ultra high power single mode lasers for aerospace and defense.

We will rely on our core scientific strengths and strong cash flow to optimize investment in strategic initiatives critical to the long-term success of the company. These initiatives include a greater mix of high power lasers, along with differentiated features and solutions in new markets and applications. We expect to grow faster in these new product areas, enabling IPG to deliver strong growth in revenue and cash flow. I want to thank our talented employees for their hard work during a challenging year. As ever, I remain confident in IPG's ability to execute during this period delivering on our mission to make our fiber laser technology the tool of choice in mass production.

Finally, I've asked Dr. Eugene Scherbakov, IPG's Chief Operating Officer, to participate in our earnings calls. As many of you know, Eugene is a long-serving member of IPG's executive leadership team with extensive operational and technical knowledge of our business. He will be able to provide you with additional insights into IPG's operational performance during the quarter. With that, I'll turn the call over to Eugene.

Eugene Scherbakov:

Thank you Valentin and good morning everyone. I am pleased to be joining you today and on future calls to discuss the operational trends in our business.

IPG remains the clear market leader in fiber lasers with hundreds of megawatts of installed capacity. In 2019 we shipped 52 megawatts of total optical power, increasing 14% year over year. We continue to see aggressive pricing among China-based competition, which intensified toward the end of the second quarter last year. Since that time, pricing has been more stable. For the year, the decline in average price per kilowatt has affected the dollar value of units sold, but our ability to rapidly reduce costs has limited the gross margin impact from these price reductions.

Our team is focused on further cost reductions throughout the manufacturing process that we believe will significantly reduce the cost of our high power laser solutions from 1 to 6 kilowatts, which account for the majority of our high power units sold. When combined with the full benefit of the cost actions we undertook in the second half of 2019, we believe these measures will help us sustain our industry leading margin profile and cash returns.

We will continue to manage our cost structure to the business environment, targeting gross margin of 45% to 50%. Excluding inventory provisions we were at the bottom of this range during the fourth quarter. We executed well in controlling manufacturing expenses, decreasing them by more than 10% from the third quarter. This benefit was mostly offset by a reduction in costs absorbed into inventory due to lower production levels. However, this enabled us to generate cash from inventory as the reduction in the value of inventory on hand was greater than inventory provisions.

Examining our performance by region, revenue in China decreased 21% year over year and represented approximately 30% of total sales. As we had expected, performance was impacted by weaker demand due to the US-China trade conflict, slow down in capital investment and greater than average price declines. In Europe, revenue decreased 17% year over year. The demand environment in Europe remains very challenging as key macroeconomic indicators remain weak in the region.

Revenue in North America increased 30% year over year driven by the acquisition of Genesis. Excluding Genesis, sales in North America increased 23% year over year with strong growth in welding, surgical and communications applications. Our growth in North America is a testament to our diversified portfolio strategy where increasing adoption of our beam delivery accessories and complete laser solutions was augmented by growth in advanced applications, communications and medical laser products. Sales in Japan decreased 37% year over year. Similar to Europe, the macro economy in Japan remains weak; however, we continue to work on a number of substantial laser welding projects in the region. Sales in Korea increased 2% year over year on strength in battery welding, and sales in Turkey decreased 18% year over year given macroeconomic pressures affecting cutting business in the region.

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.

Revenue in the fourth quarter declined 7% year over year to $307 million. Revenue from materials processing applications decreased 11% year over year and revenue from other applications increased 42%. Sales of high power CW lasers decreased 15% year over year and represented approximately 51% of total revenue. Reduced revenue from high power CW lasers in cutting and welding was partially offset by strength in other materials processing applications. Pulsed lasers sales decreased 33% year over year, with growth in green and ultraviolet pulsed lasers offset by lower sales of puled lasers for marking and fine processing applications. Systems sales increased 69% year over year including Genesis and increased 43% year over year excluding Genesis.

Medium power laser sales decreased 32% on softness in additive manufacturing and the transition to kilowatt-scale lasers in cutting, while QCW sales increased 14% year over year. Other product sales increased 6% year over year driven by growth in beam delivery accessories and service revenue. For the full year 2019 revenue declined 10% year over year and 10% on an organic constant currency basis.

Q4 GAAP gross margin was 40.5%, which declined 1,000 basis points year over year. Excluding higher inventory reserves, Q4 gross margin would have been 45.2% and normalizing for a full bonus accrual gross margin would have been 44.1%. Compared with the year-ago period, higher inventory reserves reduced gross margin by 570 basis points, less favorable absorption of manufacturing expenses reduced gross margin by 250 basis points, and the acquisition of Genesis reduced gross margin by 180 basis points.

Fourth quarter GAAP operating income was $243 thousand and operating margin was 0.1%. Excluding higher inventory reserves, foreign exchange and charges related to asset impairment and restructuring, Q4 operating margin would have been 20.9% and normalizing for a full bonus accrual operating margin would have been 17.8%. As a reminder, our fourth quarter expenses did not include an accrual for employee bonuses because of 2019 underperformance relative to our budget. For modeling purposes, you should assume quarterly bonus expense of approximately $4 million in cost of sales and $5 million in operating expenses in 2020.

Net loss was $4 million and or $0.08 per diluted share. Higher inventory reserves and charges related to impairment of goodwill and other long-lived assets and restructuring reduced EPS by $0.99. In addition, foreign exchange losses reduced EPS by a further $0.08 and discrete tax items benefited EPS by $0.08.

If exchange rates relative to the US Dollar had been the same as one year ago, we would have expected revenue to be $4 million higher and gross profit to be $2 million higher. The effective tax rate in the quarter was 245%. The effective tax rate was increased by non-deductible charges related to impairment of goodwill and other long-lived assets and restructuring and decreased by certain discrete benefits in the quarter. On a non-GAAP basis, excluding these effects the underlying fourth quarter tax rate was approximately 27%.

We ended the quarter with cash, cash equivalents, and short-term investments of $1.18 billion and total debt of $42 million. More than 60% of our cash is held in the US with most of the remaining cash balance in Germany. Effective operational execution resulted in cash provided by operations of $130 million during the quarter. Capital expenditures were $26 million in the quarter and $134 million for the year versus our revised target of less than $150 million. During the quarter we repurchased 105 thousand shares for $15 million. For the full year 2019 we repurchased $41 million worth of stock and have $84 million remaining on our current buyback authorization.

We ended the year with $285 million shippable backlog, down 16% year over year and total backlog including frame agreements of $693 million, down 3% year over year. Fourth quarter book to bill was 1.0, in line with normal seasonality.

Turning to guidance, we believe we have significant long-term growth opportunities in laser welding, fine processing of electric vehicle batteries and our portfolio of new products addressing opportunities in micro processing, medical, systems and beam delivery solutions. Current demand for our leading-edge laser solutions remains mixed, with strength in North America and emerging regions such as India and Southeast Asia offset by ongoing macro softness in Europe and Japan. Prior to the government-extended Lunar New Year holiday, there were signs that business in China was firming, with order flow having picked up in December and January. However, ongoing business disruption related to the novel coronavirus outbreak makes forecasting our business in China and the impact on global demand very challenging at this point. China is a large and important market for IPG, with repercussions for other markets, and we continue to monitor the situation closely.

For the first quarter of 2020, IPG expects revenue of $220 million to $250 million. The company expects the first quarter tax rate to be approximately 26%. IPG anticipates delivering earnings per diluted share in the range of $0.00 to $0.30, with 52.9 million basic common shares outstanding and 53.6 million diluted common shares outstanding. This guidance assumes approximately $45 million in reduced revenue and $0.45 lower EPS from business disruption related to the novel coronavirus outbreak. This estimate is based on the facts and understanding we have at this time.

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, goodwill and other impairment charges, product demand, order cancellations and delays, competition, tariffs, trade policies, health epidemics 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, Eugene 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.