# IPG Photonics Corporation
# Second Quarter 2020 Conference Call Prepared Remarks

**Operator:**

Good morning, and welcome to IPG Photonics' second quarter 2020 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 the impact of the COVID-19 pandemic on our business and those detailed in IPG Photonics' Form 10-K for the period ended December 31, 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, August 4, 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. Despite the continued challenges to our business from the COVID-19 pandemic, we delivered second quarter results above our guidance range. Our strong performance was driven by better-than-expected performance in China and strength in new products. Before discussing the latest trends in our business, I want to provide you with an update on our ongoing efforts to deal with the COVID-19 pandemic.

The well-being of our people, our customers and our partners remains our highest priority. We are continuing to manufacture and service our solutions in all regions, having employed additional distancing, cleaning, air purification and disinfection procedures while providing all employees with masks to wear in our facilities. With the state of Massachusetts now in Phase Three of its reopening plan, it has allowed us to bring additional employees back into our headquarters, so that staffing levels in the US will be more commensurate with our facilities in Germany and Russia.

Our commitment and support of workforce health and safety extends to COVID-19 response efforts in local communities worldwide. In addition to donations in China, Russia and Europe, we have donated face masks to Massachusetts General Hospital in Boston and several other local hospitals. In addition, we recently made a sizable financial contribution to the Worcester Educational Development Fund to purchase Chromebooks for online education programs this fall. IPG is committed to supporting economic empowerment and diversity efforts in our local communities. Furthermore, we believe that cultivating a diverse and inclusive work environment, one that fosters a culture of mutual respect, helps ensure our growth and success in the marketplace. Thirty years ago when I founded IPG, our vision was to create a company that would redefine our industry and whose day-to-day operations were committed to improving our communities and our society as a whole. Since that time we have demonstrated a commitment to fostering, cultivating and preserving a culture of merit, where our greatest ideas and innovations have come from the diverse collaboration of experiences and backgrounds of our people.

Turning to our results, we continue to benefit from signs of industrial demand recovery in select regions, most notably China. In particular, demand for high power CW and pulsed lasers for cutting and battery processing applications remains robust. However, global demand trends remain very uncertain at this time, and we have seen continued push outs and delays of select welding and systems projects in Western Europe, North America and other parts of Asia. This uncertainty continues to make forecasting our business very challenging in the near- to medium-term. We continue to believe that our large and diverse advanced materials and components technology platform, our efficient R&D model, and our strong balance sheet and free cash flow provide us ample flexibility to respond to business disruptions and emerge from the pandemic in a stronger competitive position.

Although the demand environment remains mixed, we are demonstrating good progress in our core markets thanks to our technology differentiation and low cost production capabilities. In the cutting market we delivered strong sequential growth in both our rack mounted one to four kilowatt lasers for the high volume market and our ultra-high power lasers for leading-edge cutting systems. With the launch of our new ultra-compact YLR-U series of lasers, IPG is once again raising the bar in the high volume cutting sector. The YLR-U has extended optical performance, with the smallest size and lowest weight in the industry, and for the first time in this range of devices provides full protection against humidity penetration. The YLR-U delivers unmatched performance in an ultra-compact form factor with a record power to volume ratio.

At the high end of the market, we expect to benefit from a substantial increase in order volumes for our 20 and 30 kilowatt lasers and ultra-high power optical heads. These lasers not only enable 50% to 100% faster cutting speeds than a 15 kilowatt device, but are capable of processing materials with 20 to 50 millimeters of thickness or greater. This improvement in both productivity and flexibility is driving the replacement for the first time of plasma cutting machines and lower power laser solutions, particularly in the machine shop and construction industries. Moreover, these lasers provide the superior beam parameters, record wall plug efficiency and unique high reliability that are the hallmarks of our solutions, and which drive superior return on investment for our customers.

Our Adjustable Mode Beam lasers continue to gain traction in the welding industry, most notably in electric vehicle battery welding. Our AMB products produce superior speed and weld quality over competing solutions thanks to the broadest range of beam tunability, which enables spatterless welding. During the quarter we again more than doubled sales of high power nanosecond pulsed lasers used for foil cutting and other electric vehicle battery processing applications, and we expect strong growth in this application to continue during the second half of the year.

Product innovation remains core to IPG's success. During the second quarter emerging product and application sales were one-quarter of total revenue, increasing nearly 20% sequentially despite softer demand trends in several new product categories due to the COVID-19 pandemic. Sales of medical lasers increased more than 150% year over year as we continue to sell our "gold standard" thulium laser solution and consumable fibers for urology and other soft tissue applications. Advanced applications revenue increased more than 40% year over year in Q2 driven by strength in government, semiconductor and the resumption of cinema projection system shipments.

Unfortunately the COVID-19 pandemic limited our ability to make further progress selling our green, ultraviolet and ultrafast pulsed lasers into emerging micro processing applications given the restricted travel and shutdown of customer sites and our applications labs during the quarter. However, we continue to target more than 50 new projects for these lasers across a wide range of applications processing glass, ceramics, composite materials, numerous crystals, circuit boards, OLED film, batteries and solar cells.

We are continuing investments in a number of next-generation solutions that we plan to launch over the next six to 12 months with significant disruptive potential. These include our newest outstanding handheld laser welder, multichannel QCW lasers for spot welding applications, and kilowatt-scale pulsed lasers for ablation and cleaning applications. Beyond materials processing, we continue to develop new soft tissue medical treatments, mid-infrared lasers for molecular-level resolution online spectroscopy, inspection, sensing and biomedical research applications, new high-speed transceivers for the telecom and datacom markets, as well as new ultra-high power single-mode lasers and amplifiers for defense applications.

I want to conclude my remarks by thanking our people for their strong execution over one of the most challenging periods in our company's history. I remain confident that our technology and manufacturing leadership will enable us to accelerate growth out of this pandemic and 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 Eugene.

**Eugene Scherbakov:**

Thank you Valentin and good morning everyone. I will begin my remarks by discussing the effects of COVID-19 on our production. All three of our major production facilities in Germany, the US and Russia remain open. We have increased production at our facilities in Massachusetts as the state continues to progress on its reopening. Our facilities in Germany and Russia are operating on a largely normalized basis, albeit with social distancing and enhanced cleaning and filtration measures in place. I want to reiterate that the safety of our employees, their families, our business partners and community remain our highest priority.

We continue to benefit from our vertically integrated production model, which enables key technological and cost advantages over the competition while minimizing supply chain disruptions. The current constraints on our business primarily relate to restrictions on travel that affect our sales and applications development efforts as well as the shipment of products around the world. Shipping costs were again elevated this quarter while we saw delays and pushouts in project-based work due to the COVID-19 pandemic. However, we continue to believe we have the ability to meet the near-term demand for our products.

We continue to benefit from the cost reduction actions we undertook in the second half of 2019 as total manufacturing and operating expenses increased approximately $2 million sequentially while revenue increased $47 million quarter over quarter.

Examining our performance by region, revenue in China decreased 11% year over year but more than doubled sequentially, representing approximately 49% of total sales. We benefited from strong sequential improvement in sales into cutting, welding and battery processing driven by a pickup in order activity in March and April that continued through the latter half of Q2, albeit at a more moderate pace. We continue to face aggressive competition in the region, but we continue to maintain share at key accounts while anticipating a strong mix of lasers at 10 kilowatts or greater in the second half of 2020.

In Europe revenue decreased 24% year over year due to the effects of COVID-19 on many countries in the region. Similarly, revenue in North America decreased 16% year over year with strong growth in medical lasers and advanced applications more than offset by declines in laser and systems sales for materials processing. Sales in Japan decreased 16% year over year. While COVID-19 infections in the region are below other countries, the continual stopping and restarting of economic activity has delayed many significant projects within our welding and cutting businesses in the region. Sales in Korea decreased 33% year over year as economic activity in the region remained subdued, and sales in Turkey decreased more than 70% year over year as the COVID-19 pandemic severely affected cutting sales 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 second quarter was $296 million, which declined 19% year over year but increased 19% quarter over quarter. Revenue from materials processing applications decreased 21% year over year and revenue from other applications increased 36%. Sales of high power CW lasers decreased 26% year over year and represented approximately 53% of total revenue. Sales of ultra-high power lasers at six kilowatts or greater represented more than 50% of total high power CW laser sales. Pulsed lasers sales increased 4% year over year, with growth in high power pulsed lasers partially offset by lower sales of lower power pulsed lasers for marking applications. Systems sales decreased 37% year over year as growth in systems for medical device manufacturing was offset by lower sales of other IPG laser systems and Genesis non-laser systems. Medium power laser sales decreased 31% on continued softness in additive manufacturing and the transition to kilowatt-scale lasers in cutting, while QCW laser sales decreased 14% year over year but increased 39% quarter over quarter from sequential improvement in consumer electronics applications. Other product sales increased 21% year over year driven by growth in medical laser sales.

Q2 gross margin was 46%, which declined 350 basis points year over year. Compared with the year-ago period, the decline in gross margin was driven primarily by less favorable absorption of fixed manufacturing expenses. In addition, increased shipping costs were partially offset by lower inventory provisions compared with the year-ago period.

Second quarter GAAP operating income was $47 million and operating margin was 16%. During the quarter we recognized a foreign exchange loss of $13 million primarily related to revaluation of US dollar cash and other assets in Russia given the appreciation of the Ruble versus the US dollar. In addition, we incurred a charge of $1 million, which includes the non-cash write-off of machinery, as well as other charges for severance and lease termination relating to our strategic decision to exit the submarine networking business. The foreign exchange loss and other charges reduced Q2 operating margin by approximately 470 basis points. Q2 net income was $38 million or $0.71 per diluted share. The previously referenced foreign exchange loss and charge for restructuring and asset impairment reduced EPS by $0.20. The effective tax rate in the quarter was 23%.

If exchange rates relative to the US Dollar had been the same as one year ago, we would have expected revenue to be $8 million higher and gross profit to be $4 million higher.

We ended the quarter with cash, cash equivalents, and short-term investments of $1.2 billion and total debt of $40 million. Strong operational execution resulted in cash provided by operations of $73 million during the quarter. Capital expenditures were $20 million in the quarter. For the full year 2020, we now expect capital expenditures of approximately $100 million, below our prior target of $115 million to $125 million. During the quarter we repurchased 131 thousand shares for $16 million.

Second quarter book to bill was greater than 1.0 with strong bookings growth in China, offset by weaker order trends in other regions. As expected, the pace of order growth in China moderated as the second quarter progressed while we have seen modest improvement in order trends in other regions. However, visibility into a recovery in global demand remains uncertain at this time. We continue to benefit from near-term growth opportunities in ultra-high power cutting, electric vehicle battery processing and systems and devices for the medical industry. We believe the strides we are making in higher power products within our core materials processing business and new solutions will enable us emerge from the pandemic in a stronger competitive position.

For the third quarter of 2020, IPG expects revenue of $280 million to $310 million. The company expects the third quarter tax rate to be approximately 26%. IPG anticipates delivering earnings per diluted share in the range of $0.70 to $1.00, with 53.0 million basic common shares outstanding and 53.5 million diluted common shares outstanding. Financial guidance provided this quarter is subject to greater risk and uncertainty given the COVID-19 pandemic and its associated impacts to the global business environment and government policies.

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 will be participating in a number of virtual investor conferences this quarter. Have a great day everyone.