

# IPG Photonics Corporation

## Second-Quarter 2015 Conference Call Prepared Remarks

### Operator:

Good morning, and welcome to IPG Photonics' second-quarter 2015 conference call. Today's call is being recorded and webcast. At this time, I would like to turn the call over to Angelo Lopresti, IPG's Senior Vice President, General Counsel and Secretary, for introductions. Please go ahead sir.

### Angelo Lopresti:

Thank you and good morning everyone. With us today is IPG Photonics' Chairman and Chief Executive Officer, Dr. Valentin Gapontsev, and Senior Vice President and Chief Financial Officer, Tim Mammen.

Statements made during the course of this conference 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 known and unknown 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, 2014 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 28, 2015. The Company assumes no obligation to publicly release any updates or revisions to any such statements. We will post these prepared remarks on our website following the completion of the call. I'll now turn the call over to Dr. Valentin Gapontsev.

**Valentin Gapontsev:**

Good morning everyone.

First of all, I want to congratulate our management team and employees worldwide for a truly outstanding quarter. Sales grew 22.3% year-over-year, EPS increased 25% to a new record, margins expanded and book-to-bill exceeded one considerably. Revenues rose to \$235 million as we continue to expand market penetration of fiber lasers in materials processing at growth rates that outpace the competition. Gross margin was 54.7% and EPS was \$1.15, including \$0.04 per share in foreign exchange losses.

I'd like to note that the year-over-year growth in the first half of 2015 would have been considerably higher if you exclude the forced drop in prices of our major products in dollars from an 18% drop in exchange rate between Euro and Dollars. For example, in units, we increased sales of our kW class fiber lasers by 40% whereas in Dollars it was fixed sales growth of 27% only. The same situation happened with mid-power lasers (55% growth in units) and QCW lasers, where we increased unit sales by 116%.

IPG's performance indicates that our fiber laser products continue to displace CO2 and YAG lasers in many applications. In addition to the gains made by high and mid-power product we have seen increased traction from our QCW product. We continue to gain sales over our

competition because in addition to the already recognized benefits of fiber lasers IPG has the scale to produce optical components and finished product in high volumes with very short lead times and also deliver exceptional service and support. We are extremely flexible and can respond to customer demand to produce devices for their specific application needs with increasing integration of optical delivery accessories, software and application know-how.

We have a strong position in our core markets because of our technology and performance advantages. Our proprietary components and vertical integration provide us the best-in-the-industry cost structure. The scale of our manufacturing process is unmatched by anyone, even competitors who have been manufacturing fiber lasers since the early 2000s. We will not be complacent with our current technology. As other companies begin development, we continue to push the technology forward and raise the bar for the competition.

Areas of development include new materials, new technology, new components, optical subsystems, more sophisticated electronics, software, new kind of lasers, optical output accessories, material process technologies, laser-based macro and microsystems, and a wide range of new applications. For example, in the materials area, we developed a new, highly efficient technology for growing nonlinear LBO crystals, unique zinc sulfate and selenide crystals doped by chromium and iron for high power lasers in the mid-IR range, crystals for AOMs, unique low index polymers for fiber cladding, new technology to make large diameter fiber preforms, efficient photorefractive glass for volume Bragg gratings and new thin film technologies. These will form the basis for the development of new components, fibers and diodes to improve existing products as well as the development of new products.

I would like to take a moment now to address some recent news that one of our large laser customers in China has announced plans to develop fiber lasers. There have been concerns regarding the near-term impact on IPG. First and foremost, this company remains an IPG customer. Their announcement has not affected orders or our current relationship with them and we are confident that they will remain our serious customer in the future.

As you may know, they are not our first customer or competitor to try to develop a fiber laser. The long-term reliability, performance and price points that IPG offers have so far been unmatched by competition due to our continued investments in technology. Further, development of an internal supply chain will take others several years and is subject to many risks. We are now many generations ahead, further limiting, we believe, the ability of competition to catch-up. For example, two of our competitors have been manufacturing fiber lasers since the early 2000s. However, neither has been able to achieve significant share or match IPG's competitive performance during this time period. We have a robust head start on the competition, but we are also not standing still. We are currently and continually developing the technology for the next generation of fiber lasers demanded by the market, which we believe provides us with an important step up on the competition.

We believe that the announcements by our Chinese customer and others recently validates IPG's long-held belief that fiber lasers are the winning solution now and for the future. The acknowledgment of the benefits of fiber lasers compared to legacy technologies may actually hasten the displacement of CO<sub>2</sub> and other conventional lasers by fiber lasers and create a larger opportunity for us to take market share. The total laser market was estimated to be \$4.7

billion in 2014 with fiber lasers accounting for \$1.1 billion or about 23% of that market. Through 2019, fiber lasers are projected by modest analysts to grow 15% annually to account for 35% of total laser sales, which is estimated to be a \$6.6 billion market in 2019. I can say with confidence that IPG will be at the forefront of the expansion of the fiber laser market and we are in the best position to compete with legacy technologies and newcomers to the fiber laser field.

We are strengthening our relationships in China with all customers and winning accounts from other fiber laser companies. IPG looks to expand its international footprint as demand increases for its products and to better serve its customers globally. We have plans underway to establish new sales centers in Europe, in South America and other locations over the next quarters.

As our results indicate, we maintained our strong momentum in Q2. Our backlog, order flow and book-to-bill remain at strong levels in our three main geographies and we expect that to continue in the near term. We continue to be focused on gaining share in our established materials processing applications, developing new product applications successfully that will expand our available market, and applying our lasers in novel applications beyond our core applications in materials processing.

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

**Tim Mammen:**

Thank you Valentin and good morning everyone.

Second-quarter revenue grew 22% to \$235.1 million from \$192.2 million a year ago.

Materials processing sales increased 21% year-over-year to \$224.5 million, accounting for approximately 95% of total sales during the quarter. The continued strong performance of materials processing was driven primarily by cutting, welding and additive manufacturing applications such as 3D printing where we expanded in many existing accounts and added new accounts.

Sales to other markets, including advanced applications, telecom and medical applications, which accounted for approximately 5% of IPG's total revenue, increased by approximately 54% to \$10.7 million. The increase was primarily related to medical and telecom sales, and to a lesser extent advanced applications.

High-power laser sales, which accounted for 56% of total revenue, increased 27% year-over-year to \$131.8 million. This growth was driven primarily by strong demand in cutting, welding and brazing applications. We saw demand from cutting OEMs expand and stronger growth in welding and brazing. In addition, we experienced an account win from a fiber competitor.

Pulsed laser sales decreased by 1% year-over-year to \$32.1 million. While pulsed laser sales had a slight decline, we continued to see growth in our high-power pulsed product with strong demand for marking and engraving applications as well as for cleaning and ablation. At the same time, we saw our recent pricing strategy in China for low-power pulsed lasers achieve success in both unit and revenue growth.

Continued demand for fine-processing applications, particularly cutting of thinner materials, as well as 3D printing applications, resulted in medium-power laser sales increasing 23% year-over-year to \$26.6 million, or 11% of total revenues.

Sales of QCW lasers, which are mostly used for fine welding, percussion drilling of holes and some glass cutting, increased by 95% year-over-year to \$15.7 million and accounted for 7% of total revenues. QCW fiber lasers are displacing lamp-pumped YAG lasers at an increasing rate.

Revenue from low-power lasers increased 21% to \$3.7 million due to strong growth in medical applications.

Sales of other products, which include amplifiers, diode lasers, green lasers, mid-IR lasers, integrated laser systems and certain components, increased 40% year-over-year to \$9.4 million, primarily as a result of higher telecom sales and sales for advanced applications.

Service, parts, lease and other revenue, including accessories, totaled \$15.7 million, a decrease of 3% from \$16.2 million last year including \$1.8 million of deferred revenue recognized in this quarter as compared to \$4.1 million of deferred revenue recognized in Q2 2014.

### **Now looking at our Q2 performance by geography...**

Sales in Asia increased to \$137.5 million, or by 35% year-over-year. Within that region, China sales increased 42% to \$92.9 million. We saw strong demand from cutting, welding and marking and engraving applications. Further, we won an account from a fiber competitor for mid-power lasers, and we are pursuing growing our business with large OEMs and integrators there. In Japan, sales increased 28% year-over-year to \$18.8 million as a result of demand from cutting OEMs as well increased sales in welding applications for the automotive industry and heavy industry. Finally, Western Asia, which includes Turkey, continues to be an area of good growth with sales there focused on cutting OEMs.

European sales grew 10% year-over-year to \$70.5 million, driven by gains in cutting, sintering, welding and cleaning and stripping applications offset by a decrease in sales for marking and engraving application and by some weakness in Russia. In addition, US Dollar reported growth in Europe was also most affected by the depreciation of the Euro as we discuss later. We are pleased to note that during the quarter, we received a multiple unit order for our new 3-beam brazing laser from a European automotive customer and have strong interest from several other automakers.

North American sales increased 2% year-over-year to \$26.7 million primarily due to increases in welding and telecom applications offset by declines in marking and cutting applications as compared to a reasonably strong cutting applications performance in Q2, 2014.

### **Now, working our way down the income statement . . .**

Gross margins of 54.7% were at the high end of our range of 50% to 55% as a result of the strong revenue performance and manufacturing efficiency.

Sales & Marketing expenses decreased to 3.4% of sales as compared to 4.2% of sales, a year ago while remaining consistent at \$8.0 million in real dollars in both periods.

As a percentage of sales, R&D expenses were down at 6.4%, compared with 7.0% of sales, a year ago. In real dollars, R&D expenses increased to \$15.1 million from \$13.4 million a year ago, as we continue to focus on launching innovative new products in order to maintain our technology lead. The increase in R&D spending related to increase personnel cost and increased cost of materials used in R&D development projects.



General & Administrative expenses decreased to 6.4% of total sales as compared to 6.8% one year ago. General and Administrative spending increased to \$15.0 million, from \$13.1 million, a year ago. The increase in real dollars was primarily due to increased personnel costs as well as increased accounting and legal costs, depreciation and bad debt provisions.

Operating expenses for the second quarter were \$41.3 million, including a foreign exchange loss of \$3.2 million, compared with \$35.5 million a year ago, which included a foreign exchange loss of \$0.9 million. Excluding the foreign exchange loss, operating expenses for the second quarter were \$38.1 million, compared with \$34.5 million a year ago.

The foreign exchange loss of \$3.2 million related primarily to US dollar weakening against the Euro during the quarter. The FX loss amounted to \$0.04 per share.

Second-quarter operating income was \$87.4 million, or 37.2% of sales, compared with \$68.7 million, or 35.8% of sales, in the second quarter of last year. Foreign exchange transaction losses reduced operating margins by 1.3 and 0.5 percentage points in 2015 and 2014, respectively.

Our tax rate in the second quarter was 30.0% and does not include any benefit related to potential R&D tax credits that might become available later in the year if the credit legislation in the U.S. is re-enacted.

Net income for the second quarter increased by 26.1% to \$61.3 million. On a diluted per share basis, we reported \$1.15 for the second quarter compared with \$0.92 a year ago.

If exchange rates relative to the U.S. Dollar had been the same as one year ago, which were on average Euro 0.73, Russian Ruble 35 and Japanese Yen 102, respectively, we would have expected revenue to be \$19.7 million higher, gross profit to be \$9.9 million higher and operating expenses would have been \$4.0 million higher.

**Now, turning to the balance sheet...**

We continue to maintain a strong balance sheet, ending the quarter with cash and cash equivalents of \$571.5 million, and \$22.3 million of debt including lines-of-credit. During the quarter we repaid \$11 million related to the remaining balance on one of our U.S. long-term notes.

At June 30, 2015, inventory was \$190.8 million, up 12% from \$171.0 million at year end 2014. Our current level of inventory on hand amounts to approximately 163 days, compared with our target range of less than 180 days.

Accounts receivable were \$169.8 million at the end of the second quarter, or 66 days' sales outstanding, compared with \$143.1 million at December 31, 2014, or 63 days' sales outstanding.

Cash provided by operations during the quarter was \$49.4 million.

Capital expenditures for the quarter totaled \$18.6 million. We continue to expect the capex run-rate for the full year 2015 to be approximately \$60 to \$65 million, excluding business acquisitions.

In the second quarter, book-to-bill was above 1. As we enter the second half of 2015, we remain focused on establishing partnerships with new OEMs and end-users, deepening our relationships with existing customers and developing the next generation of fiber-laser based products to address new markets and applications.

**And now for our expectations ...**

We currently expect revenues for the third quarter to be in the range of \$235 million to \$250 million. We anticipate Q3 earnings per diluted share in the range of \$1.15 to \$1.30. The midpoint of this guidance represents quarterly revenue and EPS growth of approximately 21% and 17%, respectively, year-over-year. However, it should be noted that net income in the year-ago quarter included a foreign exchange gain of \$0.05 per share and excluding this gain the midpoint of EPS guidance is equal to growth of approximately 23%.

The EPS guidance is based upon 53,442,000 diluted common shares, which includes 52,657,000 basic common shares outstanding and 785,000 potentially dilutive options at June 30, 2015. This guidance is based upon current market conditions and expectations and is subject to the risks we outline in our reports with the SEC. It also assumes exchange rates relative to the U.S. Dollar of Euro 0.92, Russian Ruble 57 and Japanese Yen 124, respectively. I want to reiterate that we do not attempt to forecast transaction gains or losses related to changes in exchange rates.

With that, Valentin and I will be happy to take your questions.

## **After Q&A**

**Valentin:**

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