

# IPG Photonics Corporation

## First-Quarter 2017 Conference Call Prepared Remarks

### **Operator:**

Good morning, and welcome to IPG Photonics' first-quarter 2017 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 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 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, 2016 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, May 2, 2017. 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.

IPG first quarter 2017 revenue and EPS were well-above the high end of our guidance ranges driven by rapid growth across our core products, applications, and geographies. First quarter orders came in at a record level and based on our current backlog, we believe we are in excellent position to deliver another strong quarter in Q2.

As a reminder, we are focused on three key initiatives for 2017: (1) enhancing our leadership position within our core materials processing markets; (2) expanding into new products and applications; and (3) generating industry-leading profit and cash flow.

Starting with our core markets, we had our strongest Q1 ever. The pace at which our fiber lasers are replacing conventional lasers and non-laser-based technologies is accelerating. At the same time the competitive environment seems to have shifted more in IPG's favor, as the competition is finding it increasingly difficult to match our power advantages, global scale, low cost, and high quality. And we continue to drive adoption with a goal of making fiber lasers the preferred tool of choice across both typical laser and non-laser materials processing applications. Over the last 18 to 24 months we have made considerable investments to enhance our product portfolio, our sales staff, and our service capabilities. These investments, we believe, played a crucial role in our ability to execute this quarter, helping us better-identify opportunities and win business in our core markets.

Sales of high-power lasers increased 42% year over year due to rapid growth in cutting and welding, our two largest applications. Total kilowatts of high-power lasers sold in the first quarter increased by more than 60% year over year in revenue and 70% in units. In addition, more than 30% of our high-power laser sales were at 6 kilowatts and above, compared with 20% a year

ago. Demand for 6 to 10 kilowatt lasers for cutting applications continues to gain significant momentum. With IPG's reliable and cost-effective lasers, customers use the higher power kilowatt lasers to cut faster and develop new applications. In fact some customers are planning to introduce cutting systems with 12 kilowatt lasers. Our results suggest that the higher productivity and lower operating cost of fiber lasers are accelerating the replacement of the installed base of CO2 cutting systems.

I'm pleased to report total welding sales, driven by high-power and QCW, increased nearly 60% year over year to a record level. We have shipped in the quarter about 2000 units more than last year. We believe this validates our thesis that laser welding has tremendous opportunities displacing existing lasers, such as lamp-pumped YAG, and non-laser technologies in joining applications.

Demand within our core business was especially strong in China, which despite being our largest geographic market, grew 89% year over year. We are also continuing to expand into the systems market, where sales have increased year over year thanks to strong growth in systems for macro materials processing and our seam stepper, which replaces traditional spot welding technology, and other technologies.

Outside our core materials processing market, we grew sales of our telecom products by 221%, driven both by our Menara acquisition and solid organic growth. Advanced applications grew 148% thanks to strong uptake in fiber laser technology used for R&D, and defense applications. We are also pleased to report the first sales of RGB lasers which are now being in cinemas with our OEM projection partner.

As Tim will explain, our first quarter was a very strong one from a profitability perspective, highlighting the strong returns generated from our double-digit revenue growth and industry-leading margins. Earnings per diluted share of \$1.38 increased 50% year over year.

We are off to a fast start in 2017, demonstrating our execution across our end markets. Our order flow remains strong. Although our visibility into the second half of the year, particularly Q4, remains somewhat limited at this time, we continue to benefit from the secular growth of fiber lasers within materials processing and other applications. Our capabilities within these markets are currently unmatched, while the competitive landscape appears to be shifting in our favor. Our vertical integration and process know-how drive a technology and cost advantage, which when combined with our manufacturing, sales and service scale, enables us to continue share gains in materials processing. Over time, we expect these advantages to drive similar gains within micro materials processing applications and new industries like displays, medical, R&D, and defense.

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

**Tim Mammen:**

Thank you Valentin and good morning everyone.

Before I begin my comments on the quarter, I'd like make a few opening remarks. First, I'd like to welcome Jim Hillier, our new Vice President of Investor Relations. Quite a few of you have met Jim already, and we believe he will be a valuable addition to the IPG team. While Angelo Lopresti, our General Counsel and Corporate Secretary, no longer needs to make the introductory comments on these earnings calls, he remains actively engaged in our investor relations process, and a valued member of the IPG senior leadership team. I'd also like to thank Sharon Merrill Associates for ten great years of IR advisory service to IPG. Finally, I want to draw your attention to the financial data workbook posted to our investor relations website in conjunction with our earnings release. This Excel-based model contains IPG historic financial results and key metrics over the last 10 years. We hope you find this to be a valuable resource as you update or build your financial models on IPG. Because much of the data we typically

review in our prepared comments can be found in this model, I will focus our prepared comments on the key highlights and significant changes during the period. We believe this change in format will enable us to spend more time addressing your questions on our earnings calls.

Turning to the results, first quarter revenue grew 38% to a record \$286 million. Materials processing sales increased 33% year over year and accounted for approximately 92% of total sales during the quarter. Year-over-year growth rates accelerated in applications for cutting and welding, our two largest end markets, while marking and engraving grew by a single digit percentage, year over year. Notably, fiber laser sales for welding applications were at a record level, growing nearly 60% versus the year-ago period. Sales to other markets were up 140% year over year driven by strength in telecom and advanced applications. Menara generated \$5 million in revenue during the quarter.

China, our largest geographic region from a revenue standpoint, was also among our fastest growth areas, up 89% year over year. We believe this is being driven by secular growth across several different industries, multiple applications, and a healthy consumer electronics investment cycle. In addition, China-based machine tool customers are rapidly adopting our high-power fiber lasers as the product of choice for their cutting systems due to the faster performance, lower power consumption, greater versatility, and higher reliability of our solutions over conventional lasers and other competing products. As Valentin noted earlier, we have invested considerable resources in China to enhance our sales coverage, our service capabilities, and our applications development work. We believe these investments are enabling us to better-identify opportunities, build and expand customer relationships, and enhance our overall execution. In the first quarter, we saw some results from our investments through new OEM customer wins and displacing other fiber laser makers at other customers.

Beyond China, other areas of strength included Korea and Russia, where we are gaining sales in the cutting market. In the US, welding sales were particularly strong this quarter -- the result of considerable work by our application engineers to demonstrate the power, performance, and flexibility of our solutions within advanced automotive welding applications. In Europe, despite a subdued auto market, we saw strong growth driven by high power laser sales into cutting applications. Sales in Japan were down double digits due to seasonal softness and expected lower volume at one of our largest cutting OEMs due to timing of order flow. We expect sales in Japan to rebound during the remainder of the year.

High-power laser sales increased 42% year over year to a record \$168 million driven by cutting and welding applications. A key element of our strategy is to drive an increase in demand for high-power lasers in new and existing applications, which we believe will expand the total market for our fiber lasers over time.

QCW was another standout in the quarter, with record sales of \$21 million growing 148% year over year from strength in fine welding for consumer electronics applications and percussion hole drilling for aerospace applications. We are encouraged by the rapid growth of QCW in the quarter and expect another strong quarter in Q2. However, a moderation in the consumer electronic cycle with the completion of key capacity additions later this year, for example, would cause our rate of growth in QCW to slow. Medium-power laser sales declined 13% due to decreased demand for fine cutting applications and the transition to higher-power lasers at 1 kilowatt and above.

Working our way down the income statement, gross margin of 55.0% was down 20 basis points from Q1 2016 and at the top of our guidance range of 50% to 55%. We were able to largely offset declines in average selling prices with: (1) improved manufacturing efficiency; (2)

component and material cost reductions and (3) a larger proportion of our sales coming from high-power CW, high-power pulsed and QCW, which carry a higher gross margin.

First-quarter operating income was \$101 million, or 35.5% of sales, compared with \$70 million, or 33.8% of sales, in the first quarter of last year. Excluding foreign exchange, operating margins increased to 37.1% from 36.2% in Q1 of 2016, as we leveraged our costs over higher sales volume. As a percentage of revenue, sales & marketing expenses decreased to 3.8% from 3.9% in the same quarter last year; R&D expenses decreased to 8.0% from 8.4%; and G&A expenses increased decreased to 6.2% from 6.7%. We were able to achieve leverage in all three areas despite higher spending related to product development, new applications and manufacturing processes, and the expansion of our sales force.

Our tax rate in the first quarter was 26.0%. The tax rate in Q1 2017 was lower due to the adoption of the revised accounting guidance whereby the excess tax benefit arising from equity grants is now recognized in net income. This benefit was \$4 million in Q1 and benefited the tax rate by 4 percentage points. In Q2 we expect the tax rate to be approximately 30% excluding any effects relating to equity grants.

Net income for the first quarter increased by 51.9% to \$75 million. On a diluted per share basis, we reported \$1.38 for the first quarter compared with \$0.92 a year ago. In Q1 2017 the foreign exchange loss decreased EPS by \$0.06, as compared with the same quarter last year decrease of \$0.06, while the change in accounting standard related to stock option exercise tax benefit increased EPS by a net amount of \$0.07, including the impact of the increase in dilutive shares related to the same accounting standard.

If exchange rates relative to the U.S. Dollar had been the same as one year ago, we would have expected revenue to be \$10 million higher, gross profit to be \$7 million higher and operating expenses to be \$1 million lower.

We continue to maintain a strong balance sheet, ending the quarter with \$863 million in cash, cash equivalents, and short-term investments, and \$40 million million of debt. Our current level of inventory on hand amounts to approximately 183 days, which is just slightly above our target range of 2 turns or approximately 180 days and above the 2016 year end level of 176 days.

Days sales outstanding was 57 at quarter-end, compared with 51 at the end of Q4 2016 and 64 days a year ago.

Cash provided by operations during the quarter was \$51 million. The \$14 million decrease in operating cash flow versus Q1 2016 primarily stems from a \$31 million increase in cash used for receivables and a \$19 million increase in cash taxes paid. Receivables, which are impacted by the timing of when revenue is recognized during the quarter, can fluctuate from period to period. Cash taxes can also fluctuate depending on the timing and amount of estimated tax payments. It is also worth noting that Q1 operating cash flow tends to be below the annual run rate due to the payment of cash bonuses during the quarter. We expect to see a significant increase in operating cash flow during the remainder of the year.

Capital expenditures totaled \$22 million for the quarter, and we continue to expect \$90 million to \$100 million of capex for the full year including up to \$15 million to upgrade our corporate aircraft, net of proceeds from selling the existing one.

During the quarter, we purchased 108 thousand shares for \$13 million as part of our share repurchase program to mitigate the dilutive impact of shares issued under our various employee and director equity compensation and employee stock purchase plans. We have now repurchased 210 thousand total shares for \$21 million since the program began last July.

Moving on to guidance, for the second quarter of 2017, we expect revenues to be in the range of \$320 million to \$340 million. We anticipate Q2 earnings per diluted share in the range of \$1.50 to \$1.70. The mid-point of this guidance represents quarterly revenue and EPS growth of



approximately 31% and 28%, respectively, year over year. The magnitude of our Q1 out-performance and current Q2 revenue guidance has exceeded our expectations when compared to those assumed in our annual guidance of 10% to 14% revenue growth in 2017. As such, we believe the stronger-than-expected performance and guidance for the first half of the year should be treated as additive to our full-year revenue growth outlook. However, it should not be used, at this time, as an assumption for out-performance in the second half of the year. While order flow remains strong, our visibility into the back half of the year, particularly Q4, remains somewhat limited.

As discussed in more detail in the "Safe Harbor" passage of our news release today, actual results may differ from both our full year and quarterly guidance due to various factors including, but not limited to, product demand, order cancellations and delays, competition and general economic conditions. This guidance is based upon current market conditions and expectations, and is subject to the risks outlined in the Company's reports with the SEC, and assumes exchange rates relative to the U.S. Dollar of Euro 0.94, Russian Ruble 56, Japanese Yen 112 and Chinese Yuan 6.90, respectively. As a reminder, we do not attempt to forecast changes foreign exchange rate.

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