IPG Photonics Corporation

Second-Quarter 2016 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' second-quarter 2016 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, 2015 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, 2016. 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.

Our second-quarter results continue to demonstrate IPG's fiber laser technology leadership position. We achieved record quarterly revenue of $252.8 million, gross margin of 54.5% and earnings per diluted share of $1.25, a 9% improvement over the same period last year. In addition, we completed the acquisition of Menara Networks, expanding IPG's telecommunications offerings.

IPG's commanding leadership position in our core markets is the result of our advanced technology and performance advantages. Our ultra-high grade proprietary components and vertical integration provide us with the best-in-the-industry figure of merit, i.e. quality and cost. At the same time, the unmatched scale of our manufacturing capabilities enables us to meet our customers' increasing demand for different types of lasers in high volumes. We also continuously push our technology forward as we raise the bar for fiber laser innovation. These advantages are enabling us to bolster our leadership position in our existing markets.

We believe that we are at least maintaining market share as evidenced by the fact that total kilowatts of high power & medium power lasers increased again by more than 20% from Q2 2015 to Q2 2016 while revenue for these product lines increased by approximately 6% only. The difference between revenue growth and total kilowatts sold is due to lower selling prices related in part to competition because we want to make sure that we maintain market share. It is a significant achievement but it does mean that we have to invest again in the production capacity and operating structure in order to support the volume of product and work hard to reduce cost and maintain target gross margins.

At our investor day in May we outlined the breadth of IPG's growth opportunities. I would like to highlight a few of these new key products and market opportunities.

We continue to work on diversifying our business and developing new products for new applications. Year-to-date our systems business has grown by slightly more than 50%. This growth has mostly come from the U.S., while in Russia we continue to work on numerous opportunities with our new unique orbital laser welding system for oil well casings, unique systems for welding transcontinental gas pipelines, unique new technology for welding large titanium alloy parts and other machine systems. Our welding systems have recently been certified according to National Standards during this quarter and proven to have significantly faster welding speeds with record weld quality.

We are continuing to work on the Laser Luminaire system for cinema projection and currently have several prototypes in long-term internal test and continue to build fast growing interest from several Tier 1 OEMs. Our low-power UV marking system is now ready for launch and we are in discussion with several customers about evaluating the system. Some of these potential customers have many hundred production lines around the world using UV markers. Similarly, we are building the first production batch of our ultra-fast pulsed lasers in the short-picosecond range and femtosecond range with the intention of providing these to prospective customers for testing and evaluation. While the medical business is likely to take a longer time to qualify we are continuing to work on several interesting applications in dental, urology, ophthalmology and aesthetic areas.

During the quarter we also closed on the acquisition of Menara Networks, an innovator of enhanced optical transmission modules and systems, allowing IPG to offer more integrated telecom solutions and expanding our current telecom product offerings. The acquisition is in line with our strategy to make bolt-on acquisitions that provide us with the talent, technology and products to enter large complementary markets.

I want to note the success we are having with the increasing adoption of our 8 to 10 kilowatt fiber lasers with Tier 1 cutting system OEMs. The power, quality and reliability of these lasers are unique, which contributed to their adoption by several OEMs in Europe and China.

Also, our high power welding heads are starting to gain traction in the locations where we introduced them. These new advanced heads are a better solution for our customers and we have developed a relationship with other companies to accelerate their adoption and improve their performance. On other product development news, we are looking forward to the testing in Q3 of our new UV integrated marking system for plastics. This is a large opportunity for IPG. This product will take advantage of the same value propositions that historically allowed IPG to penetrate new and large applications, namely high quality beam, higher up time and lower price.

As we enter the second half of 2016, we remain focused on improving our existing products, launching innovative new products and applications that broaden IPG's presence beyond our core markets, strengthening our technology lead and positioning IPG to expand our business with existing and new OEMs. We are making significant progress on the testing and development of these new product lines and applications and look forward to their launch to the world market.

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

Tim Mammen:

Thank you Valentin and good morning everyone.

Second-quarter revenue grew 8% to a record $252.8 million from $235.1 million a year ago. Materials processing sales increased 6.5% year-over-year to $239.1 million, accounting for approximately 95% of total sales during the quarter. The increase was primarily driven by solid demand for IPG’s core cutting and marking applications, as well as strength in emerging applications, including laser sintering, annealing and ablation.

Sales to other markets, including advanced applications, telecom and medical applications, which accounted for approximately 5% of IPG's total revenue, increased by approximately 28.9% to $13.7 million. The increase was primarily due to improved telecom sales, driven by IPG’s recent acquisition of Menara Networks. This was partially offset by lower sales of medical applications to one customer.

High-power laser sales, which accounted for 56% of total revenue, increased 7% year-over-year to $141.4 million. This growth, which demonstrates our continued leadership in this area of the market, was driven primarily by strong sales in cutting and welding applications. As Valentin mentioned, overall growth of high-power lasers was impacted by lower selling prices as kilowatts of power sold increased by more than 20%.

Pulsed laser sales increased by 14% year-over-year to $36.6 million. We continued to see strong growth in our high-power pulsed product with strong demand for marking and engraving applications as well as for cleaning and ablation.

Medium-power laser sales increased 2% year-over-year to $27.1 million, or 11% of total revenues. Higher demand for fine-processing, additive manufacturing and laser sintering applications continues to be offset by increased pricing pressure in China and elsewhere due to greater competition.

Sales of QCW lasers, which are mostly used for fine welding and cutting, increased by 3% year-over-year to $16.2 million and accounted for 6% of total revenues. The increase is primarily related to increased sales for fine welding applications.

Revenue from low-power lasers decreased 18% to $3.1 million due to lower medical sales year-over-year.

Other Revenue including amplifiers, laser systems, service, parts, accessories and change in deferred revenue, increased by 13% year-over-year to $28.3 million, primarily as a result of higher telecom and laser systems sales.

Now looking at our Q2 performance by geography…

Sales in Asia increased to $143.1 million, or by 4% year-over-year. Within that region, sales from China increased 4% to $96.4 million, driven by continued demand for welding and cutting applications. On a constant currency basis, China was up double-digits year-over-year. This growth was achieved despite increased pricing pressure in China and growing competition. In Japan, sales increased 8% year-over-year to $20.3 million as we benefited a little bit from the strong Yen.

In Western Asia we saw sales decreased to $12.7 million from $14.7 million in Q2 2015 due to lower sales of lasers for cutting applications.

European sales increased 9% year-over-year to $77.0 million, driven by strength in cutting and ablation applications and record sales in laser sintering. We experienced good growth in Germany related to increased demand for marking and engraving applications. We also saw strong growth from countries where we have recently made investments or recently hired new managers and sales personnel including Poland, India, the United Kingdom, Spain and Eastern Europe.

North American sales grew 21% year-over-year to $32.3 million, driven primarily by continued strength in cutting applications and increased sales in welding applications as we expand our presence with US automakers and their suppliers. This was partially offset by lower sales of medical and advanced applications.

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

Gross margins of 54.5% were strong and towards the top end of our guidance range of 50% to 55% as a result of the strong revenue performance and continued reductions in the cost of our components. These benefits were offset by an increase in unabsorbed and period manufacturing expenses and by inventory provisions which totaled approximately 2% of revenue, or $5.8 million.

Sales & Marketing expenses increased to $9.7 million from $8.0 million a year ago, and were slightly higher as a percentage of sales to 3.8% from 3.4%, respectively. We continue to invest in this area by expanding our geographic locations and hiring experienced sales specialists to cover some of our product and application introductions.

Research & Development expenses increased to $18.4 million from $15.1 million a year ago. As a percentage of sales, R&D increased to 7.3% from 6.4% of sales in the same quarter last year. R&D continues to focus on improving existing products, developing new manufacturing processes and launching innovative new products and applications in order to strengthen our technology lead and allow us to penetrate new markets.

General & Administrative spending in total dollars increased to $16.2 million from $15.0 million a year ago, while they were flat as a percentage of sales at 6.4%.

Operating expenses for the second quarter were $42.7 million, including a foreign exchange gain of $1.6 million, compared with $41.3 million a year ago, which included a foreign exchange loss of $3.2 million. Q2 2016 operating expenses included approximately $1.4 million of operating expenses and amortization related to the Menara acquisition.

Second-quarter operating income was $95.0 million, or 37.6% of sales, compared with $87.4 million, or 37.2% of sales, in the second quarter of last year. Excluding foreign exchange, operating margins were 37.0% and 38.5% in 2016 and 2015, respectively.

Our tax rate in the second quarter was 29.75%.

Net income for the second quarter increased by 9% to $67.1 million. On a diluted per share basis, we reported $1.25 for the second quarter compared with $1.15 a year ago. In Q2 2016 the foreign exchange gain increased EPS by $0.02, while in the same quarter last year it reduced EPS by $0.04.

If exchange rates relative to the U.S. Dollar had been the same as one year ago, which were on average Euro 0.90, Russian Ruble 53, Japanese Yen 121 and Chinese Yuan 6.12, respectively, we would have expected revenue to be $3.2 million higher, gross profit to be $1.1 million higher and operating expenses would have been $1.0 million higher.

Now, turning to the balance sheet…

We continue to maintain a strong balance sheet, ending the quarter with $587.3 million in cash and cash equivalents, $126.8 million in short-term investments, and $42.4 million of debt. During the quarter we used cash of $46.5 million to complete the Menara acquisition. In addition, we purchased the Marlborough manufacturing and office facility for approximately $23.8 million to increase capacity and support future growth. We financed that purchase with debt.

At June 30, 2016, inventory was $241.3 million, up 18.4% from $203.7 million at year end 2015. Our current level of inventory on hand amounts to approximately 191 days, compared with our target range of approximately 180 days. $7.3 million of the increase related to the acquisition.

Accounts receivable were $151.5 million at June 30, 2016, or 55 days' sales outstanding, compared with $150.5 million at December 31, 2015, or 62 days' sales outstanding.

Cash provided by operations during the quarter was $41.3 million.

Capital expenditures for the quarter totaled $45.9 million.

Now, a summary of our new share repurchase program...

Today, we announced that our Board of Directors authorized a share repurchase program to mitigate the dilutive impact of shares issued under our various employee and director equity compensation and employee stock purchase plans. Under the new anti-dilutive program, aggregate share repurchases are limited to $100 million over a period ending June 30, 2018. Also, shares of common stock repurchased in the new program cannot exceed the number of shares issued upon exercise or release to employees and directors under our various employee and director equity compensation and employee stock purchase plans from January 1, 2016 through December 31, 2017. Share repurchases will be made periodically in open-market transactions using the Company's working capital, and are subject to market conditions, legal requirements and other factors. In addition, management has been granted the authority to establish a trading plan under Rule 10b5-1 of the Securities Exchange Act of 1934 as part of the repurchase program. The share repurchase program authorization does not obligate the Company to repurchase any dollar amount or number of its shares, and repurchases may be commenced or suspended from time to time without prior notice.

And now for our expectations for the upcoming quarter…

We currently expect revenues for the third quarter to be in the range of $245 million to $260 million. We anticipate Q3 earnings per diluted share in the range of $1.12 to $1.27. The mid-point of this guidance represents quarterly revenue and EPS growth of approximately 4% and 1% EPS, respectively, year-over-year.

In addition, based on near-term customer demand and macro-economic factors, we continue to expect full-year 2016 revenue growth to be in the range of 5-10%.

This guidance is based upon current market conditions and expectations and is subject to the risks we outline in our reports with the SEC. As a reminder, we do not attempt for forecast foreign exchange rate changes. The foreign exchange rates used for our guidance as well as the shares outstanding used to calculate EPS are disclosed in our press release.

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

After Q&A

Valentin:

Thank you for joining us this morning. Again, we look forward to speaking with you on next quarter's call. Have a great day.