IPG Photonics Corporation

Third-Quarter 2016 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' third-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, October 27, 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.

As you have found already in our press-release, IPG achieved another record sales for the third quarter of 2016. Sales of $266 million were well above the high end of our guidance range, and we delivered third-quarter earnings per diluted share of $1.29. This includes foreign exchange losses that reduced earnings per share by $0.04. In addition, strong order flow across nearly all geographic regions resulted in a Q3 book-to-bill ratio that was above one, in spite of Q3 is typically a seasonally weak quarter for orders.

Our third-quarter sales performance reflects a rebound across our core materials processing applications from the weakness we experienced at the beginning of the year. We are encouraged by the robust growth we saw in our core cutting applications, which achieved a record quarter in sales driven by increased demand in Asia and North America, in particular, as well as certain parts of Europe. Our OEM cutting customers are tending to move up the power scale for their cutting systems, allowing them to improve processing speeds and cut thicker metals. This is a continuation of an ongoing trend that has seen cutting OEMs transition from using lasers with output power of 2KW to 4KW, 6KW and now 10KW. In the fourth quarter we also expect demand to ramp for our 12KW fiber lasers. This trend to move up the power scale is significant for IPG because the ASPs are higher and because these higher power fiber lasers are only available from IPG. In a similar manner, we have seen marking and engraving OEMs buying higher power pulsed lasers which also benefits our competitive position.

Compared to the year ago quarter welding and cladding applications across a variety of industries including automotive, airspace, oil goods drilling, gas pipe, railway, nuclear, construction, heavy industry, and battery welding, continue to be a bright spot for IPG. Welding applications continue to grow as our fiber lasers are more widely accepted due to the much higher quality and speed of the welds, lower cost of equipment and better opportunities for automation and control of the processes. The highest benefit that laser welding provides is in processing of new advanced materials such as high strength steels, alumina, titanium and other alloys as well as multiple metal compositions. As we continue to develop new applications and processes for welding and cladding and leverage the fact that our lasers can be used in the field we expect our sales to continue to grow. Our pipeline in this core application is rich.

We also are encouraged by the greater acceptance we are seeing for our laser seam steppers in the market. We continue to have numerous projects evaluating their use primarily for joining of different metals in automotive. We expect this trend will continue, driving increased sales in 2017.

We also forcing the development of new products and applications that will expand our growth opportunities in new markets. Our UV marking system is undergoing evaluation with several customers. Other UV laser with much higher energy per pulse and average power is in final stage of qualification. In addition, we continue to ramp up our marketing efforts for our new femto and short picosecond lasers as well as high power visible and unique line of mid-IR lasers. Our revolutionary laser luminaire systems for premium 3D cinema and other large screen applications are going very well in qualification with multiple top customers. We have demonstrated that IPG's luminaire delivers the new level of brightness and dynamic range that the industry is demanding for a new generation of projectors.

In medical, our created recently new branch, IPG Medical, has made serious progress in the development of a new generation of medical systems for dental, urology, ophthalmology and aesthetic applications based on IPG fiber lasers. The most impressive result we have made in urology, where our new products Urolase120 and Urolase500 have been demonstrated directly in clinics showing serious advantages to compare with the currently dominant Holmium-laser technology that some of tier one players in the market segment claim it as a revolution. Now we are making a clinical qualification of the products in different countries.

We are seeing strong momentum in our business as we enter the final quarter of our fiscal year. We have significant opportunities to expand our business through both existing and new OEMs and end-users as we develop innovative products to address applications beyond our core markets. While the fourth quarter is seasonally historically weaker, we believe we are well positioned for continued strong year-over-year sales and earnings growth and are confident in our short- and long-term opportunities.

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

Tim Mammen:

Thank you Valentin and good morning everyone.

Third-quarter revenue grew 9% to a record $266.0 million from $243.5 million a year ago. Materials processing sales increased 10% year-over-year to $246.3 million, accounting for approximately 93% of total sales during the quarter. This growth was primarily driven by higher demand for IPG’s core cutting and welding applications. We also saw solid demand for marking and engraving, laser sintering, hole drilling and cladding applications.

Sales to other markets, including advanced applications, telecom and medical, accounted for approximately 7% of IPG's total revenue, were flat year-over-year at $19.7 million. Strong growth in telecom sales, driven by our recent acquisition of Menara Networks, was offset by lower sales of advanced applications and medical. Menara generated $5.1 million in revenue during the quarter.

Before discussing the performance of different product lines I would like to mention that ASPs for several key product categories stabilized in Q2 and Q3 this year even though they were lower when compared to Q3 2015.

High-power laser sales, which accounted for 58% of total revenue, increased 17% year-over-year to a record $153.0 million. This growth was driven by continued strength in cutting and welding applications, as well as increased demand for 1-KW lasers for 3D printing.

Pulsed laser sales decreased by 2% year-over-year to $34.4 million. We continued to see strong growth in our high-power pulsed product driven by increased demand for marking and engraving applications, as well as cleaning and ablation. We also saw double-digit growth in sales of our green pulsed lasers, a newer product line. This growth was more than offset by weaker sales of our lower power pulsed lasers.

Medium-power laser sales decreased 7% year-over-year to $25.0 million, or 9% of total revenues. Higher demand for welding applications was offset by a decrease in demand for fine-processing and laser sintering applications for 3D printing. The slightly lower medium power 3D printing sales in Q3 2016 is attributable to the timing of orders and deliveries following a strong Q2 2016 as well as the increase in 1-KW high power lasers being purchased for this application.

Sales of QCW lasers, which are mostly used for fine welding and cutting, decreased by 41% year-over-year to $11.7 million and accounted for 4% of total revenues. As expected, this decrease was due to lower demand from consumer electronics applications, which resulted in substantially slower unit volumes for this application. Sales of QCW lasers can be lumpy due to the timing of big projects.

Revenue from low-power lasers of $3.0 million were flat year-over-year due to lower medical OEM sales year-over-year.

Other revenue including amplifiers, laser systems, service, parts, accessories and change in deferred revenue, increased by 40% year-over-year to $38.9 million, primarily as a result of higher telecom sales, an increase in parts and service revenue and lower deferred revenue.

Now looking at our Q3 performance by geography…

Sales in Asia increased to $150.1 million, or by 16% year-over-year. Within that region, sales from China increased 9% to a record $102.1 million, driven by continued demand for cutting applications. On a constant currency basis, China was up double-digits year-over-year. This growth was achieved despite the competitive dynamics there for pulsed and medium power lasers. In Japan, sales increased 77% year-over-year to $23.4 million, driven by strong demand from cutting OEMs.

In Western Asia, sales decreased to $11.4 million from $13.0 million in Q3 2015. Although this decrease was expected, I would like to note that the actual decrease in sales to Turkey was less than we anticipated despite the geopolitical uncertainty in that region.

European sales increased 3% year-over-year to $78.8 million, driven primarily by strength in cutting, welding and telecom, which was partially offset by lower sales of marking applications. Sales to Russia increased double digits driven by increased sales of laser systems.

North American sales grew 1% year-over-year to $36.7 million, driven primarily by increased strength in materials processing and telecom. This was offset by lower sales of medical and advanced applications.

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

Gross margins of 54.4% were towards the top end of our guidance range of 50% to 55%. This strong gross margin was achieved despite expenses related to the step-up to fair value of inventory acquired in the acquisition, amortization of intangibles and slightly lower absorption of manufacturing expenses all of which was offset by continued reduction in component and other material costs.

Sales & Marketing expenses increased to $10.5 million from $7.7 million a year ago as we continue to expand our geographic locations and hire experienced sales specialists. As a percentage of sales, sales & marketing expenses increased to 3.9% from 3.2% in the same quarter last year.

Research & Development expenses increased to $20.5 million from $16.2 million a year ago. As a percentage of sales, R&D increased to 7.7% from 6.7% 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 expenses increased to 6.3% of sales, or $16.8 million, from 6.0% of sales, or $14.7 million, a year ago. The increase in G&A is primarily related to headcount, stock based compensation, accounting and legal expenses. Operating expenses for the third quarter were $50.7 million, including a foreign exchange loss of $2.9 million, compared with $43.7 million a year ago, which included a foreign exchange loss of $5.1 million. Q3 2016 operating expenses included approximately $3.0 million of operating expenses and amortization related to the acquisition.

Third-quarter operating income was $94.1 million, or 35.4% of sales, compared with $89.6 million, or 36.8% of sales, in the third quarter of last year. Excluding foreign exchange, operating margins were 36.5% and 38.9% in 2016 and 2015, respectively. The decrease in third-quarter operating margin was primarily due to the continued investment in selling and R&D as well as increased operating expenses related to the acquisition.

Our tax rate in the third quarter was 26.9%. The tax rate benefited from the release of tax reserves following the recent conclusion of a tax audit as well as an increase in benefits related to research tax credits. In Q4 we expect the tax rate to be approximately 29%.

Net income for the third quarter increased by 10.3% to $69.2 million. On a diluted per share basis, we reported $1.29 for the third quarter compared with $1.18 a year ago. In Q3 2016 the foreign exchange loss reduced EPS by $0.04, while in the same quarter last year it reduced EPS by $0.06. Furthermore, the acquisition was dilutive to EPS by $0.03 all of which related to acquisition accounting charges including the impact of the step-up in value of inventory, retention bonus and amortization of intangibles.

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 63, Japanese Yen 122 and Chinese Yuan 6.28, respectively, we would have expected revenue to be $2.0 million higher, gross profit to be $1.1 million higher and operating expenses would have been $0.1 million higher.

Now, turning to the balance sheet…

We continue to maintain a strong balance sheet, ending the quarter with $645.6 million in cash and cash equivalents, $127.0 million in short-term investments, and $41.6 million of debt.

At September 30, 2016, inventory was $242.4 million, up 19.0% from $203.7 million at year end 2015. Our current level of inventory on hand amounts to approximately 184 days, compared with our target range of approximately 180 days.

Accounts receivable were $162.7 million at September 30, 2016, or 56 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 $87.7 million.

Capital expenditures for the quarter totaled $30.8 million. We now expect capex for full year 2016 to be in the range of $110 million to $125 million for facilities and equipment which is slightly higher than our previous estimate. The increase primarily relates to the timing of expenditure on facilities and our co-generation facility in Oxford. This range excludes amounts spent to acquire businesses during the year.

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

In July 2016, 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. Mid-quarter, we started the buy-backs, spending approximately $3.5 million to repurchase 41,800 shares of stock under our authorized $100 million share repurchase program. It should be noted that we only started the program halfway through the quarter.

And now for our expectations for the upcoming quarter…

We currently expect revenues for the fourth quarter to be in the range of $255 million to $270 million. We anticipate Q4 earnings per diluted share in the range of $1.17 to $1.32. The mid-point of this guidance represents quarterly revenue and EPS growth of approximately 13% and 5%, respectively, year-over-year.

Based on this guidance, full-year 2016 revenue growth will be within our previously stated target range of 5-10%. We are encouraged by the rebound we are seeing in our core applications and we continue to see excellent opportunities to expand our business through both existing and new OEMS and end-users as we develop innovative products to address applications beyond our core markets.

It should be noted 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.