IPG Photonics Corporation

Fourth-Quarter 2016 Conference Call Prepared Remarks

SPEAKER DIAL-IN: 877-407-3139

Operator:

Good morning, and welcome to IPG Photonics' fourth-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.

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Any forward-looking statements made on this call are the Company's expectations or predictions only as of today, February 14, 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.

I'm pleased to report that IPG delivered another quarter of record results, capping off an excellent year. The fourth quarter of 2016 marks our 10th anniversary as a public company, and as I reflect on our journey from the smaller company that IPG was ten years ago to the billion-dollar market leader we are today, I feel tremendous pride in all that our team has achieved.

Ten years ago, IPG generated less than \$150 million in revenue. At that time we told you that our targets were 50-55% gross margin and 30-35% operating margin. Since then, our revenue has increased more than six-fold, and our gross and operating margins are at the top end and above our original ranges, respectively. More importantly, I'm optimistic we can continue our strong financial performance over the next ten years. Even at our current size, IPG has very significant opportunity to expand within our addressable markets, as we continue to raise the bar in terms of the power, performance, and wide diversity of our products which open a lot of new applications and unique niches for us.

To highlight our progress in 2016, I will focus you on three key initiatives we discussed at last year's investor day — initiatives we believe will maximize long-term value for you, our shareholders: (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.

Let me start with our core markets. In 2016 we grew our industry leading market share of lasers within our core metal processing markets, winning new OEM accounts in cutting, welding, cladding, cleaning, drilling, additive manufacturing, and other applications. Our biggest growth driver in 2016 was within high output power lasers. We continue to move up the power scale, enabling customers to improve productivity and cut and weld a diverse range of thicker metals. And last year demonstrated that we are still far away from saturation in the market sector, as we sold again near 30% more optical power than in 2015, what is similar to the midrange during last five years. At the same time we see fast growth in sales of our high power output optical accessories such as delivery cables, switches, collimators, cutting and welding heads, scanners... and so on.

In parallel, we also are continuing our penetration in new materials processing applications, such as annealing, ablation, nanostructuring, 3D printing, cleaning, and joining of multi-material structures. Further, last year we have made a very essential step ahead in extending into the systems market by selling more than hundred full laser systems for various applications.

Shifting focus to products outside our core materials processing market, IPG experienced strong sales growth in telecom products driven both by our Menara acquisition and robust organic growth. In addition, we continue to make good progress in the medical and advanced applications markets. In the dental, urology, surgical, and cosmetic fields, we are entering into partnerships with major medical companies to leverage our technology and manufacturing scale

and their distribution. Our dental laser partner BIOLASE, announced last month that its Epic Pro system featuring IPG laser technology, received US FDA clearance for commercial distribution.

In the urology application, we are working together with a one of Tier one provider to qualify and introduce revolutionary new Thulium fiber laser technology for prostate and stone removal operations.

Other our target is implementation of fiber lasers in manufacturing of medical devices like stents, pacemakers, implantable defibrillators, and so on. The market has enormous potential for our growth.

Within the display market, the transition from xenon bulbs to laser luminaires presents a significant longer-term opportunity for IPG. Our technology is featured in NEC's digital cinema projector and we are encouraged by our discussions with other equipment providers in this space. Although these markets are small relative to core materials processing, they represent multiple potential growth drivers for IPG over the next three to five years.

2016 was a very strong year from a profit and cash flow perspective. In the face of difficult macro-conditions at the start of 2016 and currency headwinds throughout the year, sales of \$1 billion increased 12% year-over-year, above our guidance for 5% to 10% growth, driven by strength in our core products. Gross margin of 54.9% was at the high end of our long-term guidance range of 50% to 55%, while full-year EPS increased 7%. Operating cash flow grew even faster than earnings, increasing 14% year over year to \$292 million in 2016, highlighting the strong returns generated from our double-digit revenue growth and industry-leading margins.

The improvement in order flow that began around mid-2016 has continued. Furthermore, our priorities for 2017 remain the same as last year -- enhancing our core market leadership; expanding into new markets and applications; and generating industry-leading profit and cash flow. IPG's technology, when combined with our process know-how, manufacturing scale and world-wide sales and service capabilities, provide us a commercial advantage in the marketplace unmatched by our competitors. I'm confident we will continue to build on these advantages, capture new growth opportunities, and deliver increasing value to our shareholders.

In addition to the financial announcements, I also want to comment on our other important announcement earlier today. We issued a press release disclosing that Dr. Eugene Scherbakov has been appointed to serve in the newly created position of Chief Operating Officer, effective immediately. He now serves as Managing Director of IPG Laser GmbH, Senior Vice President, Europe and as a member or IPG's Board of Directors. Eugene has been the most valuable member of IPG's leadership team for more than 20 years and has been instrumental in the Company's success. We are broadening the scope of his responsibilities to include worldwide production. Dr. Scherbakov will be responsible for enhancing process uniformity for production and service and continuing the standardization of information technology across IPG's manufacturing facilities. I would like to personally congratulate Eugene on his well-deserved promotion.

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

Tim Mammen:

Thank you Valentin and good morning everyone.

Fourth-quarter revenue grew 25% to a record \$280.1 million from \$223.6 million a year ago. Materials processing sales increased 24% year-over-year to \$258.6 million, accounting for approximately 92% of total sales during the quarter. This growth was primarily driven by higher demand for IPG's core cutting sales. Sales for welding applications increased slightly and sales for marking and engraving applications slightly decreased. Although on a smaller base of revenue, we saw solid growth from other materials processing applications including ablation, drilling, cladding, and cleaning and stripping.

Sales to other markets, including advanced applications, telecom and medical, which accounted for approximately 8% of IPG's total revenue, were up 48% year-over-year to \$21.6 million.

Strong sales in telecom, driven by our recent acquisition of Menara Networks as well as robust organic growth, was offset by lower sales of advanced applications and medical. Menara generated \$5.4 million in revenue during the quarter.

High-power laser sales, which accounted for 59% of total revenue, increased 35% year-over-year to a record \$166.0 million. This growth was driven by continued strength in cutting applications and to a lesser extent cladding and 3-D printing partially offset by a slight decline in welding sales in the quarter.

Pulsed laser sales, which accounted for 10% of revenue, increased by 5% year-over-year to \$29.3 million. We saw strong double-digit growth in our high-powered pulsed product driven by

increased demand for marking and engraving using high-power pulsed lasers as well as ablation, cleaning and stripping and photo-resist patterning for flat panel display applications.

Medium-power laser sales were flat year-over-year at \$24.1 million, or 9% of total revenues.

Higher demand for fine welding applications was offset by a decrease in demand for fine cutting applications.

Sales of QCW lasers, which are mostly used for fine welding and cutting, increased by 11% year-over-year to \$12.1 million and accounted for 4% of total revenues. This increase was due to higher demand for welding and brazing applications. Sales of QCW lasers can be uneven due to the timing of end-user product introductions. Looking ahead, we expect strong growth for QCW lasers in 2017 versus 2016.

Revenue from low-power lasers increased slightly by 1% year-over-year to \$3.7 million, benefiting from an increase in semiconductor related applications.

Other revenue including amplifiers, laser systems, service, parts, accessories and change in deferred revenue, increased by 29% year-over-year to \$44.8 million, primarily as a result of higher sales from amplifiers and telecom, an increase in parts and service revenue and lower deferred revenue.

Now looking at our Q4 performance by geography...

Sales in Asia increased to \$147.4 million, or by 32% year-over-year. Within that region, sales from China increased 43% to a \$98.4 million, driven by strong welding sales in the automotive

market and continued demand for cutting applications by nearly all major OEMs. In Japan, sales increased 8% year-over-year to \$25.1 million, driven by strong demand from cutting OEMs.

In Western Asia, sales increased 5% to \$9.1 million. This growth was primarily attributable to increased sales to OEMs in Turkey as the political situation there has stabilized somewhat.

European sales increased 30% year-over-year to \$91.7 million, driven primarily by the strength of cutting and welding applications in Western Europe, but partially offset by lower welding applications and laser sintering sales within Germany. Sales to Russia increased by strong double digits driven by increased sales of lasers and systems used in cutting applications.

North American sales grew 1% year-over-year to \$40.4 million, driven primarily by an increase in demand for telecom applications as well as cladding, semiconductor and micro processing, offset by lower sales of cutting, welding and medical applications in the quarter.

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

Gross margins of 55.5% were slightly above the top of our guidance range of 50% to 55%. This strong gross margin was achieved as a result of several factors. We have improved manufacturing efficiency and the rate of growth of our manufacturing expenses was slower than the rate of sales growth in the quarter. Additionally, we continue to achieve component and material cost reductions. Finally, a larger proportion of our sales are coming from high-power lasers with more than 6KW of output power and from high-power pulsed and QCW lasers which command higher gross margins than lower power products in these categories. These benefits

were partially offset by slightly lower absorption of manufacturing expenses and declines in average selling prices.

Sales & Marketing expenses increased to \$10.2 million from \$8.6 million a year ago as we continue to invest in personnel resources and offices. For example, we opened an office in Brazil and recently hired a country manager in Mexico. As a percentage of sales, sales & marketing expenses decreased to 3.6% from 3.9% in the same quarter last year.

Research & Development expenses increased to \$22.1 million from \$17.8 million a year ago. As a percentage of sales, R&D remained flat at 7.9% compared with 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 \$19.6 million from \$14.7 million a year ago. On a dollar basis, the increase in G&A is primarily related to a \$2.9 million impairment charge for our corporate aircraft which we plan to sell and upgrade with the purchase of a longer range aircraft. In addition, G&A expenses increased due to headcount, stock based compensation, accounting and legal expenses. As a percentage of sales, general & administrative expenses increased to 7.0% from 6.6% in the same quarter last year.

Operating expenses for the fourth quarter were \$50.1 million, including a foreign exchange gain of \$1.8 million, compared with \$39.0 million a year ago, which included a foreign exchange gain of \$2.1 million.

Fourth-quarter operating income was \$106.3 million, or 37.6% of sales, compared with \$82.5 million, or 37.1% of sales, in the fourth quarter of last year. Excluding foreign exchange and the asset impairment charge, operating margins increased to 37.9% from 36.2% in Q4 of 2015, as we leveraged our costs over higher sales volume.

Our tax rate in the fourth quarter was 29.3%. In Q1 we expect the tax rate to be approximately 29.0%. Cash taxes paid in 2016 were higher year over year as a result of the timing of taxes paid in Germany.

Net income for the fourth quarter increased by 23.8% to \$75.1 million. On a diluted per share basis, we reported \$1.39 for the fourth quarter compared with \$1.14 a year ago. In Q4 2016 the foreign exchange gain increased EPS by \$0.02, as compared with the same quarter last year increase of \$0.03, while the asset impairment charge reduced EPS by \$0.03 in the current quarter.

If exchange rates relative to the U.S. Dollar had been the same as one year ago, which were on average Euro 0.91, Russian Ruble 66, Japanese Yen 121 and Chinese Yuan 6.40, respectively, we would have expected revenue to be \$5.5 million higher and gross profit to be \$3.6 million higher. The impact on operating expenses was not significant.

Now, turning to the balance sheet...

We continue to maintain a strong balance sheet, ending the quarter with \$623.9 million in cash and cash equivalents, \$206.8 million in short-term investments, and \$40.8 million of debt.

At December 31, 2016, inventory was \$239.0 million, up 17.3% from \$203.7 million at year end 2015. Our current level of inventory on hand amounts to approximately 176 days, which is below our target range of approximately 180 days and below the 2015 year end level of 185 days.

Accounts receivable were \$155.9 million at December 31, 2016, or 51 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 \$99.3 million.

We saw a 14% increase in full year 2016 operating cash flow, despite the significant increase in cash taxes paid, primarily due to a reduction in inventory and receivables days outstanding.

Capital expenditures totaled \$27.0 million for the quarter, and \$127.0 million for the year. This is slightly above our expectation for the full year of \$110 million to \$125 million, as a result of some earlier than expected purchases of facilities and equipment near year end. For 2017, we expect Capex to be lower than 2016 and be in the range of \$90 million to \$100 million. It should be noted that this range includes up to \$15 million to upgrade our corporate aircraft, net of proceeds from selling the existing one.

During the quarter, we purchased 60,974 shares for \$5.5 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 102,774 total shares for \$8.9 million since the program began last July.

And now for our expectations for the year and the upcoming quarter...

For the full year 2017, the Company expects revenue growth in the range of 10% to 14%. Our annual guidance reflects foreign currency headwinds that we estimate will reduce growth by approximately 3 percentage points. Therefore we expect local currency sales to show stronger growth this year as compared to 2016. We expect this revenue growth will translate to another strong year from a cash flow perspective.

For the first quarter of 2017, we expect revenues to be in the range of \$245 million to \$260 million. We anticipate Q1 earnings per diluted share in the range of \$1.10 to \$1.25. The midpoint of this guidance represents quarterly revenue and EPS growth of approximately 22% and 28%, respectively, year-over-year.

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 63, Japanese Yen 105 and Chinese Yuan 7.00, 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.