IPG Photonics Corporation

Third-Quarter 2015 Conference Call Prepared Remarks

Operator:

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

IPG delivered yet another strong quarter, growing revenues by 22% year-over-year to $243.5 million in the third quarter of 2015. We translated that growth into a gross margin of 54.7% and we reported EPS of $1.18 which includes a $0.06 per share impact of foreign exchange transaction losses. Year-over-year, foreign currency losses reduced our sales by 12 percentage points. In other words, sales would have increased 34% if Q3 2015 exchange rates remained the same as a year ago. Our continued strong growth reflects the penetration of our fiber lasers into new and existing applications through our diverse and expanding product line.

IPG is executing on a variety of strategies to continue its strong growth. These include expansion in established products and markets, development of new products and applications, and geographical, customer and product diversification.

In current products and markets, our European OEM cutting customers had great growth in the quarter and are moving up the power scale allowing them to improve processing speeds and cut thicker metals. In addition to benefiting from the secular shift in laser processing from legacy lasers to fiber lasers, IPG used its best-in-class products to achieve two OEM wins over another fiber laser maker.

Battery welding is an application that is growing as the demand, uses and size of batteries increase. Rechargeable batteries are everywhere - in cell phones, electronic devices, hybrid and electric cars and are now moving to the power grid. Although we are limited in saying much about specific customers, we have a robust pipeline of projects with several battery manufacturers that we are working on.

Our most recent product lines are gaining traction and performing quite well. For example, QCW lasers are displacing lamp-pumped YAG lasers at an increasing rate. Sales of QCW lasers grew 62% for year to date and Q3 was the strongest quarter ever for this product line.

Another recently introduced product that is gaining traction is our three-beam fiber laser system for brazing of zinc-coated steel for the automobile industry. We're seeing increased levels of interest in this one-of-a-kind product. In fact, we recently won a sale from the incumbent laser supplier for this application. This brazing application presents a significant opportunity for IPG in the coming years.

As we expand the range and technological capabilities of our product lines, we also are growing the breadth of the applications that these products serve. One new area is digital laser cinema projection. Our strategy is to capitalize on industry demand to improve the movie-goer's experience by replacing Xenon bulb light sources with super high lumen laser light projectors. During the quarter we completed a successful customer demonstration of the first prototype of our new, state-of-the-art RGB laser technology platform, based on speckle-free multi hundred watts scale red, green and blue lasers. We expect to deliver the prototype of the system in the first quarter of 2016.

We're also making significant progress on the testing and development of our UV and ultra-fast fiber lasers to address new micro processing applications. We currently have several units undergoing long-term testing and we expect to launch these products on a broader scale in the coming year.

In terms of product, customer and geographical diversity, IPG's unique super high- power lasers are gaining traction. During the third quarter, we shipped another 50-KW laser to NASA for materials testing. In addition, we will recognize revenue on a 50-KW welding system that was shipped in the second quarter and we have had another inquiry from a customer regarding a 50-KW laser for welding. In Russia, we developed and have tested a new and unique orbital pipe

KW welding station that has field application in oil and gas well drilling as well as infrastructure development.

In addition, we continue to pursue projects in non-materials processing applications, such as advanced, medical and telecom, because they present significant opportunities for us as evidenced by their strong growth in Q3 when sales for non-materials processing increased by 168% year-over-year.

In China, we are making progress to further diversify our OEM customers to reduce customer concentration. IPG is working well with several major integrators to deepen our relationships.

Geographically, we have plans to expand as our business demands. In Q4, we plan to open our office in Wuhan, China. Wuhan is recognized as the economic, financial and transportation capital of central China with the automobile, heavy industry, electronics, photonics, pharmaceutical, chemical, food and beverage industries being well represented. Additionally, we are looking forward to establishing new operations in Brazil, Mexico and the Czech Republic, and expanding our applications center in Silicon Valley to develop additional micro-processing laser applications closer to key customers.

As a result of our constant focus on these strategies and the secular move to fiber lasers, we can target further 10-15% revenue growth for the full year 2016 at the minimum. The target is subject to the conditions that Tim will speak about later. We target this range in the face of the potential decelerating growth in China due to uncertain economic conditions there. We believe that we are staying ahead of the competition particularly with our high power, QCW and new, more advanced products even though many companies have announced their intention to enter the fiber laser market. Our size as the world's largest maker of laser light sources, unique and integrated business model and proven history of innovation provides IPG with many advantages to reach these targets.

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

Tim Mammen:

Thank you Valentin and good morning everyone.

Let’s get right into sales by application.

Materials processing sales increased 16% year-over-year to $223.8 million, accounting for approximately 92% of total sales during the quarter. Most of the drag on revenue due to foreign exchange that Valentin mentioned and which we discuss later affected materials processing. Within materials processing, high-power lasers used for cutting applications was the strongest growth driver coupled with additive manufacturing or laser sintering and more moderate growth in welding. Strong growth in these areas was offset by a decline in sales for marking and engraving applications.

Sales to other markets, including advanced applications, telecom and medical applications, which accounted for approximately 8% of IPG's total revenue, increased by approximately 168% to $19.7 million. The increase was driven by strong growth in advanced applications and telecom, and to a lesser extent medical. Advanced applications growth was driven by government and aerospace related applications. Telecom strength was primarily due to demand for products for last-mile fiber for US cable TV access. As a reminder, advanced applications sales are typically large and uneven from quarter to quarter.

High-power laser sales, which accounted for 54% of total revenue, increased 24% year-over-year to $130.9 million. This growth was driven by continued strong sales for cutting applications, which is our largest single application, as we continue to increase our penetration of OEM cutting customers. In addition, we are continuing to see several of the OEMs increase the power levels used in their cutting systems which further benefits sales of cutting applications.

Pulsed laser sales decreased by 9% year-over-year to $35.0 million, related to the previously mentioned lower year-over-year sales for marking and engraving applications. Competition and pricing pressure for pulsed lasers has been significant and is reflected in that fact that unit sales of pulsed lasers actually increased by 10%. It is interesting to note that price competition for pulsed lasers in China may be actually moderating.

Medium-power laser sales increased 31% year-over-year to $27.0 million, or 11% of total revenues. This growth continues to be driven by sales for fine-processing applications, particularly cutting of thinner materials as well as from additive manufacturing and laser sintering applications. Although we are seeing an increased level of competition in this market, we experienced another account win from a fiber competitor.

Sales of QCW lasers, which are mostly used for fine welding, percussion drilling of holes and some glass cutting, increased by 37% year-over-year to $19.8 million and accounted for 8% of total revenues. This marks our strongest quarter ever for QCW laser sales as they are continuing to displace lamp-pumped YAG lasers at an increasing rate.

Revenue from low-power lasers decreased 6% to $3.0 million.

Sales of other products, which include amplifiers, diode lasers, green lasers, mid-IR lasers, integrated laser systems and certain components, increased 101% year-over-year to $17.1 million, primarily as a result of higher telecom sales and sales for advanced applications.

Service, parts, lease and other revenue, including accessories, totaled $10.7 million net of deferred revenue of $3.7 million, an increase of 22% from $8.8 million last year when deferred revenue totaled $2.7 million.

Now looking at our Q3 performance by geography…

Sales in Asia increased to $130.0 million, or by 15% year-over-year. Within that region, China was our best growth area. Sales there increased 29% to $93.5 million. Growth in China was primarily related to strong demand for cutting and fine processing applications offset by a decline in sales for marking and engraving applications. In Japan, sales decreased 21% year-over-year to $13.2 million mainly due to the timing of orders. We booked a very large order in the quarter from one of our main cutting OEMs in Japan, reflecting the continued penetration of cutting OEMs in this area. We shipped several multi-KW single mode lasers to a customer in Asia for an advanced application.

Despite a tepid macro-environment in Europe, we saw solid demand throughout Europe which drove a 27% increase in sales year-over-year to $76.5 million. This growth was primarily related to strong demand for cutting, laser sintering and welding applications.

North American sales grew 44% year-over-year to $36.3 million, driven primarily by increased sales in advanced applications and telecom with continued materials processing strength in cutting and welding applications. During the quarter we shipped a 50 kW fiber laser for a government application, as well as a large order of diodes to a customer in the U.S. for an advanced application.

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 maintaining manufacturing efficiency as under-absorbed manufacturing costs were approximately the same as Q3 2014. While absorption of manufacturing expenses as a percentage of revenue was slightly lower compared to Q3 2014 this was offset by total direct and indirect manufacturing costs growing at a slower rate than revenue.

Sales & Marketing expenses decreased to 3.2% of sales, or $7.7 million, from 3.8% of sales, or $7.5 million, a year ago. We saw an increase in real dollars, but a decline in the percentage of sales as we benefited from leverage in the model as a result of an increase in sales to OEMs.

As a percentage of sales, R&D expenses were the same at 6.7% of sales, compared with 6.7% a year ago. In real dollars, R&D expenses increased to $16.2 million from $13.4 million a year ago, as we continue to focus on launching innovative new products in order to strengthen our technology lead. The increase in R&D spending related to higher personnel expenses and cost of materials used in R&D development projects.

General & Administrative expenses decreased to 6.0% of total sales compared with 7.1% one year ago. General and Administrative spending in total dollars increased to $14.7 million, from $14.2 million, a year ago.

Operating expenses for the third quarter were $43.7 million, including a foreign exchange loss of $5.1 million, compared with $31.5 million a year ago, which included a foreign exchange gain of $3.6 million.

The foreign exchange loss of $5.1 million related primarily to the devaluation of the Chinese Yuan during the quarter.

Third-quarter operating income was $89.6 million, or 36.8% of sales, compared with $77.6 million, or 38.9% of sales, in the third quarter of last year. Excluding foreign exchange, operating margins were 38.9% and 37.1% in 2015 and 2014, respectively.

Our tax rate in the third 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 third quarter increased by 13.8% to $62.8 million. On a diluted per share basis, we reported $1.18 for the third quarter compared with $1.05 a year ago. In the current quarter the foreign exchange loss reduced EPS by $0.06 while in the same quarter last year it benefited EPS by $0.05.

If exchange rates relative to the U.S. Dollar had been the same as one year ago, which were on average Euro 0.75, Russian Ruble 36, Japanese Yen 104 and Chinese Yuan 6.16, respectively, we would have expected revenue to be $20.6 million higher, gross profit to be $9.5 million higher and operating expenses would have been $4.1 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 $651.2 million, and $20.4 million of debt including lines-of-credit.

At September 30, 2015, inventory was $197.6 million, up 16% from $171.0 million at year end 2014. Our current level of inventory on hand amounts to approximately 165 days, compared with our target range of less than 180 days.

Accounts receivable were $154.8 million at the end of the third quarter, or 58 days' sales outstanding, compared with $143.1 million at December 31, 2014, or 63 days' sales outstanding. Accounts receivable days benefited from strong collections in China, Europe and the U.S. In China, we discounted bank notes accelerating collection of cash and reducing, in part, our exposure to the Chinese Yuan.

Cash provided by operations during the quarter was $93.2 million.

Capital expenditures for the quarter totaled $18.2 million. We expect the capex run-rate for the full year 2015 to be on the higher end of the $60 to $65 million range previously provided. This range excludes amounts spent to acquire businesses during the year.

And now for our expectations …

Year to date, IPG's revenues have increased by 20% despite significant foreign currency headwinds and we have delivered operating margins of 38%. Looking ahead, we remain focused on continuing to penetrate our existing OEMs and developing new OEMs and end users as well as developing the next generation of innovative fiber-laser based products and applications to address new markets. While the book-to-bill was slightly below 1 in Q3 2015 this is not unusual because we typically expect the fourth quarter to be seasonally weaker. Nonetheless, we have made significant progress on the testing and development of new product lines this year and we look forward to their launch in 2016. We continue to be confident in our longer term growth opportunities.

We currently expect revenues for the fourth quarter to be in the range of $215 million to $230 million. We anticipate Q4 earnings per diluted share in the range of $1.00 to $1.15. The mid-point of this guidance represents quarterly revenue growth of approximately 7% and EPS remaining flat, respectively, year-over-year.

The EPS guidance is based upon 53,392,000 diluted common shares, which includes 52,675,000 basic common shares outstanding and 717,000 potentially dilutive options at September 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 0.88, Russian Ruble 61 Japanese Yen 120 and Chinese Yuan 6.35, respectively. I want to reiterate that we do not attempt to forecast transaction gains or losses related to changes in exchange rates.

The Q4 guidance represents about 7% revenue growth at the midpoint over Q4 2014. I want to point out that our guidance range includes double digit growth in Germany, Japan and China. Year over year we expect Q4 revenue in China to grow at about 15%. While this represents a lower rate of growth as compared to the year-to-date it is still pretty good. What is pulling down the overall Q4 expected growth rate is the U.S. which had a very strong Q4 2014 with shipments of several super high-power lasers and a large automotive order. Revenue in the U.S. is more evenly spread between Q3 and Q4 this year rather than being weighted to Q4. In addition, we are expecting a slightly weaker quarter in Turkey and Korea where macro-economic conditions have softened.

Valentin mentioned earlier that we are targeting 10-15% revenue growth at the minimum in the full year 2016. The growth will not be linear or consistent each quarter. We remind you that there can be some unevenness due to the timing of shipments, for instance with advanced application sales. Also, I want to mention that this is based upon our current outlook which can change based upon currency rates, economic conditions in the countries where we sell, competition, pricing, and timing of new product introductions, to name a few.

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.