IPG Photonics Corporation

First-Quarter 2016 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' first-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, April 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.

IPG reported revenue and EPS in-line with our guidance for the first quarter as we continued to execute on our long-term growth strategy. Revenues of $207.2 million increased 4% year-over-year or approximately 7% on a constant currency basis. Furthermore, EPS was impacted by losses related to foreign exchange. First-quarter 2016 EPS of $0.92 included $0.07 per share related to foreign exchange losses, compared with Q1 2015 EPS of $1.08, which included an $0.11 foreign exchange gain.

First a few remarks on applications last quarter. Worldwide, cutting sales continued to grow particularly in China, Turkey and North America. While welding was a bit weaker this quarter overall, we continue to see expanding opportunities in brazing and for our laser seam stepper. In addition, we developed a tri-focal welding laser for zinc-coated steel and aluminum. This solution resolves the problem of welding zinc coated sheets without a gap between the metal at first.

Furthermore, we have been qualified by a major automotive firm for all of its transmission welding projects. Three other firms have qualified us for powertrain welding applications. These customers previously used CO2. As a result of these opportunities, we expect welding sales to improve this year.

Currently our lasers have passed a qualification for many welding applications in aerospace, gas, oil, railway, and other industries, including use in the field conditions directly. For example, one of our tier one space rocket makers already uses our 30kw laser for the welding of their rocket body. As we know, such rockets have been launched into space already. For the other space rocket maker, we have shipped a unique completer portal laser station for the highly precise 5D cutting and welding of large scale shell parts for the new international space station.

In the oil industry, we have overcome a symbolic milestone by finishing, with a great success, a half year test of our new orbital laser welding system for drilling rigs directly in field conditions It is the first in the world. As a result, we have a good chance to start a commercial shipment of such stations in the second half of the year.

A similar situation is going on now with a welding of large diameter tubes for transcontinental gas pipe lines. We have developed a unique technology for such welding at first and we have passed laboratory tests of in-house developed special orbital station for 1.4 meter diameter with great success. Now we should start field tests in May. If results are positive, as we are sure, a tier one customer promised to start purchasing such multi-million dollar stations shortly.

One more of our great recent achievements with a big future is a new welding technology for large titanium and aluminum alloy parts in open air which replaces very expensive and worse quality traditional e-beam technology usually used in large vacuum chambers. We have passed all lab tests and are ready to ship a first complete portal 5D cut and weld station to the tier one customer in the first half of May. Up to ten other customers are in line already.

Continuing a theme we discussed previously, customers are moving up the power scale not only in cutting and welding but also in 3D manufacturing, and with our high power pulsed lasers that are increasingly used in ablation and cleaning processes often.

We are pleased to see a more meaningful contribution from accessories and systems which we expect to see grow over the year. Over the last several years, we invested in various technologies that complement our core fiber laser products. This is paying dividends as our cutting heads will begin to ship in China in Q2 in quantity and our new unique high power scanning heads will begin trials at customers, also in Q2.

As we expand the technological capabilities of our product lines, we also are growing the breadth of the applications that these products serve. One new area we are pursuing is the large screen 3D cinema and light shows market. During the first quarter we delivered the second prototype of our new 300 kilo-lumen unique RGB laser technology platform for cinema projection to a tier 1 customer. We attended the CinemaCon trade show in Las Vegas two weeks ago, demonstrated our digital laser luminaire to the cinema industry and saw enthusiastic interest in this new product line from major players in the industry. We believe that IPG’s laser luminaire will deliver a new standard of brightness and dynamic range which the industry is demanding for a new generation of premium 2D and 3D cinemas over the coming years.

The other applications where we plan to build or increase our market share include medical laser devices, optical communications, OLED displays, and many others. In all of the cases, we are trying to develop not only new unique laser sources and corresponding optical accessories, but also integrated solutions to serve end-customers directly, without mediators.

As you may know, recently there has been some consolidation in the industry among our peers. We do not believe this fundamentally changes the competitive dynamics of our markets. We remain focused on improving our existing products and launching innovative new products in order to strengthen our technology lead and expand into new markets. We continue to see excellent opportunities to expand our businesses through both existing and new OEMs and more and more end-users as we develop innovative products to address applications beyond our core markets. We are making significant progress on the testing and development of these new product lines and we look forward to their launch later this year.

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

Tim Mammen:

Thank you Valentin and good morning everyone.

First-quarter revenue grew 4% to $207.2 million from $199.0 million a year ago. Materials processing sales increased 3% year-over-year to $198.2 million, accounting for approximately 96% of total sales during the quarter. Within materials processing, sales for cutting applications continued to grew at a double digit rate and we started to see increasing demand for higher power lasers for this application. Several customers have launched their new cutting systems using lasers with 8-kilowatts or more of power this year so we expect that trend to continue. We also saw an increase in high power lasers used for additive manufacturing as Valentin mentioned. Overall, growth was partially offset by timing of automotive and other welding orders and lower orders for marking and engraving sales.

Sales to other markets, including advanced applications, telecom and medical applications, which accounted for approximately 4% of IPG's total revenue, increased by approximately 30% to $9.0 million. The increase was primarily due to strong performances in advanced applications and telecom.

High-power laser sales, which accounted for 57% of total revenue, increased 3% year-over-year to $118.2 million. Double digit growth in cutting applications was partially offset by a decline in welding related to the automotive industry which we believe is primarily due to the timing of projects and orders as we expect welding sales to improve over the remainder of the year. Affecting the comparison this year is that we benefited from several million dollars in revenue last year from a one-time order for a novel surface patterning application as well. We believe that we are at least maintaining market share as evidenced by the fact that total kilowatts of high power lasers increased by approximately 17% from Q1 2015 to Q1 2016. In part the difference between revenue growth and total kilowatts sold is due to the drag of foreign exchange on reported revenue, product mix and also because we continue to reduce selling prices as we decrease costs and improve performance. This is a key element of our strategy and is done in order to maintain our competitive position and also to drive an increase in the demand for high power lasers in new and existing applications which we believe will drive a continued expansion of the total laser market over time.

Pulsed laser sales decreased by 4% year-over-year to $28.6 million, due to lower year-over-year demand for marking and engraving applications as a result of increased competition as well as pricing pressure in China. At the same time, there was strong demand for our high power pulsed lasers for marking and engraving and our new generation of kilowatt class nano-second lasers which are being used in cleaning and other ablation applications.

Medium-power laser sales increased 3% year-over-year to $22.6 million, or 11% of total revenues primarily due to continued growth in fine cutting applications. Again, growth was achieved despite increased price pressure in China and elsewhere due to increased competition.

Sales of QCW lasers, which are mostly used for fine welding and cutting, decreased by 14% year-over-year to $8.6 million and accounted for 4% of total revenues. The decline is primarily related to the previously mentioned timing of orders for fine welding and hole drilling applications.

Revenue from low-power lasers decreased 14% to $3.0 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 35% year-over-year to $26.2 million, primarily as a result of higher telecom, laser system and laser accessory sales.

Now looking at our Q1 performance by geography…

Sales in Asia increased to $106.6 million, or by 2% year-over-year. Within that region, sales from China increased 9% to $61.6 million. We achieved growth in China, from continued demand for welding applications and solid growth for cutting applications in the face of FX headwinds and continuing competition as noted above. In Japan, sales decreased 5% year-over-year to $19.8 million, primarily due to the timing of orders and projects for automotive welding applications. There are a couple of other points to note in relation to this performance. First that North America is benefiting from an increase in demand for cutting lasers that is being driving by Japanese OEMs placing orders for systems directly in North America rather than Japan. Second, the macro-economic situation in Japan seems to be more challenging than elsewhere.

In Western Asia we saw solid growth in Turkey driven by higher demand from our cutting OEMs.

European sales increased 5% year-over-year to $68.3 million, driven by strong growth from our cutting OEMs, partially offset by weakness in Russia related to the economic environment there. Germany was relatively flat as higher demand for laser sintering applications and high power pulsed lasers was offset by weaker demand for automobile welding applications.

North American sales grew 11% year-over-year to $31.7 million, driven primarily by increased sales in cutting applications and continued strength in advanced applications.

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

Gross margins of 55.2% were slightly higher than our range of 50% to 55% as a result of the good absorption of manufacturing costs due to high levels of production. While the high level of production benefited gross margin it also resulted in an increase in inventory. There was also a small benefit to gross margin because in Q1 2016 we allocated some diode costs to R&D

expenses because the diode group devoted resources to designing and developing a new generation of diode chip. When this chip is introduced to production it will have better performance and lower cost.

In real dollars, Sales & Marketing expenses increased to $8.0 million from $7.5 million a year ago, while they were slightly higher as a percentage of sales to 3.9% from 3.8%, respectively.

Research & Development expenses increased to $17.5 million from $14.2 million a year ago. As a percentage of sales, R&D increased to 8.4% from 7.2% of sales in the same quarter last year. The increase in R&D spending related to higher personnel expenses and cost of materials used in R&D development projects including the diode R&D mentioned above. R&D continues to focus on improving existing products and components, developing new manufacturing processes and launching innovative new products in order to strengthen our technology lead and allow us to penetrate new markets.

General & Administrative expenses increased to 6.7% of total sales compared with 6.4% one year ago. General & Administrative spending in total dollars increased to $13.9 million, from $12.8 million, a year ago.

Operating expenses for the first quarter were $44.4 million, including a foreign exchange loss of $5.0 million, compared with $25.8 million a year ago, which included a foreign exchange gain of $8.8 million.

First-quarter operating income was $70.0 million, or 33.8% of sales, compared with $82.0 million, or 41.2% of sales, in the first quarter of last year. Excluding foreign exchange, operating margins were 36.2% and 36.8% in 2016 and 2015, respectively.

Our tax rate in the first quarter was 29.75%.

Net income for the first quarter decreased by 14.0% to $49.3 million. On a diluted per share basis, we reported $0.92 for the first quarter compared with $1.08 a year ago. In Q1 2016 the foreign exchange loss decreased EPS by $0.07, while in the same quarter last year it benefited EPS by $0.11.

If exchange rates relative to the U.S. Dollar had been the same as one year ago, which were on average Euro 0.89, Russian Ruble 63, Japanese Yen 119 and Chinese Yuan 6.15, respectively, we would have expected revenue to be $5.4 million higher, gross profit to be $2.8 million higher and operating expenses would have been $1.1 million higher.

Now, turning to the balance sheet…

We continue to maintain a strong balance sheet, ending the quarter with $613.7 million in cash and cash equivalents, $126.3 million in short-term investments, and $19.2 million of debt.

At March 31, 2016, inventory was $226.9 million, up 11.4% from $203.7 million at year end 2015. Approximately $10.6 million of the increase is related to foreign exchange translation impact. Excluding the translation effect of changes in exchange rates inventory increased by approximately $14.1 million as manufactured components and finished lasers were placed into inventory. This in turn benefited absorption of our manufacturing costs and gross margin. Our current level of inventory on hand amounts to approximately 222 days, compared with our target range of 180 days or less. On a forward looking basis inventory days are more reasonable.

Accounts receivable were $146.5 million at March 31, 2016, or 64 days' sales outstanding, compared with $150.5 million at December 31, 2015, or 62 days' sales outstanding. Total accounts receivable decreased due to the decrease in sales from Q4 to Q1 2016.

Cash provided by operations during the quarter was $64.0 million.

Capital expenditures for the quarter totaled $25.0 million. We continue to expect capex for full year 2016 to be in the range of $100 million to $110 million for facilities and equipment to increase our capacity to support our future growth. We intend to seek financing for one of the facilities that would reduce cash expenditures to between $80 and $90 million.

And now for our expectations for the upcoming quarter…

The positive takeaways from the first quarter were continued strength in our core cutting application worldwide, and overall strong growth in China and North America. Results in China were pleasing and revenue there grew 9% despite foreign exchange headwinds. Further, we saw customers increase their demand for our unique higher power products for applications such as cutting and additive manufacturing. Overall, growth was affected by foreign exchange headwinds, timing of automotive welding orders and lower QCW sales from lower demand for current microelectronics investments. We are not alone in referencing that the quarter was impacted by the ongoing mixed and uncertain macro-economic environment and a difficult start to the year, particularly in parts of Asia and Europe.

We currently expect revenues for the second quarter to be in the range of $235 million to $250 million. We anticipate Q2 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 3% and 2% EPS, respectively, year-over-year.

The EPS guidance is based upon 53,621,000 diluted common shares, which includes 52,898,000 basic common shares outstanding and 723,000 potentially dilutive options at March 31, 2016. 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 0.90, Russian Ruble 70 Japanese Yen 113 and Chinese Yuan 6.51, respectively. I want to reiterate that we do not attempt to forecast transaction gains or losses related to changes in exchange rates.

Taking into account our Q1 performance, our Q2 guidance and current macro-economic conditions, we have to recognize that our ability to achieve low double digit growth for 2016 is more uncertain than it was previously. We also have to recognize that achieving the growth target would now require growth to accelerate more than we initially estimated for the second half of this year. As a result, we have to recalibrate our growth trajectory with current data and we are adjusting top line growth targets to be within a range of 5-10% this year. These targets are based upon our current outlook which can change for foreign currency exchange rates, economic conditions in the countries where we sell, the overall growth of the laser market, competition, pricing and the timing and success of new product introductions, to name a few.

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.

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