

IPG Photonics Corporation

Fourth-Quarter and Year-End 2015 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' fourth-quarter and year-end 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, February 12, 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.

2015 was another record year for IPG as we grew our top line by 17% to \$901.3 million and our earnings per diluted share by 20% to \$4.53 per share. These results demonstrate our continued leadership position in the fiber laser industry and the operating leverage of our business model.

We successfully executed on our strategy to drive growth through the expansion of our established markets as well as the development of products to address new applications beyond our core applications. These initiatives provide IPG with many exciting opportunities in 2016 and beyond. I will highlight a few of these key new products and market opportunities.

Our recently introduced three-beam fiber laser system for brazing of zinc-coated steel for the automobile industry continues to gain traction. The unique capability of this system is that it delivers three beams to clean the metal surface and to join the metal in one process which is an advantage for the end user. There is a significant opportunity for IPG to grow this three beam application.

We are encouraged also by potential new volume projects for our laser seam stepper to weld auto bodies, and new opportunities that use our high-power fiber lasers to weld aluminum car parts. As we have said in the past, the trends in the auto industry to use high strength steel and

aluminum alloys toward lighter weight automobiles drives increased adoption of fiber lasers. Another new IPG product line which should accelerate penetration of different applications is a family of state of the art super high power 2D and 3D scanners that enables IPG to provide automotive customers with a complete solution for popular remote laser welding and cutting applications. Before customers had to use our lasers with bulky and less perfect scanners from other manufacturers, which made hardware and software integration more difficult, significantly increasing complete laser system cost, and making service more complex. Now IPG's solution has simplified these problems by providing customers with a full integrated solution.

Sales of our QCW lasers for fine processing and welding applications continue to grow as they displace lamp-pumped YAG lasers at an increasing rate. These lasers are used for battery and electronics welding in consumer electronics, for medical devices and other consumer products.

It's good news that last year we believe we have passed a breakeven point in adoption of QCW lasers by the market. In previous years potentially large customers only purchased a few units, preferring to manufacture their own flash pump YAG lasers. In the second half of 2015 a couple of top customers have made a principal decision to turn to our revolutionary new solution and we have received the first multi-hundred volume orders. We believe that the majority of other customers will follow the trend and our QCW laser share in current and new applications will continue to grow to a much more substantial share of the market. In the past we have seen similar adoption trends in the 2D cutting market.

We are expecting to have a strong year for battery welding as demand continues to increase.

We have multiple projects in development with several manufacturers and we believe this will be an application that will perform well in China this year.

Laser cleaning is another growth area for IPG, where high-power pulsed lasers are employed by our customers to clean parts or molds during the manufacturing process, as well as paint removal in aerospace, shipbuilding and other industries. Our unique multi kilowatt nanosecond fiber lasers are starting to change the situation in this large market segment.

IPG is also focused on driving growth outside of our core materials processing applications. For example, we are pursuing a very significant market opportunity in large screen 3D cinema and light shows. During the fourth quarter, we developed and delivered the first prototype of our new unique RGB laser technology platform for cinema projection to a tier 1 customer. In the first quarter, we plan to ship a new pre-production six wavelength or 6P unit with record lumens to that customer. Then in April, IPG will show its new digital laser luminaire at Cinema-Con 2016 in Las Vegas, a major show attended by all top cinema operators, Hollywood studios and projector manufacturers. The cinema industry needs urgently to improve the 3D movie-goer's experience by replacing Xenon bulb light sources with very high lumen laser lights. We believe that IPG's laser luminaire will deliver the brightness and dynamic range the industry is demanding for a new generation of premium large format 3D cinemas. The same platform at a reasonable price would start to enable more rapid displacement of the bulbs currently used as the light source in the cinema industry.

Additionally, we have developed and will introduce this year a new line of high brightness blue diode laser modules with an average power up to 200W. These unique diode modules are requested by market for use in projector systems, direct imaging systems, biotechnology instrumentations and variety of other applications

Next, we are preparing to introduce our low-power UV and ultra-fast fiber lasers to the market in the coming months. The launch of these perfect products marks a significant milestone for IPG as they allow us to penetrate new micro-processing applications.

Another significant medium- to long-term growth opportunity is in medical applications. We recently created a separate company, IPG Medical. We have hired experienced key scientists in this field who are working with our Russian company and leading medical researchers developing new medical applications using our fiber lasers. For example, we have been working in the urology market, where we have been testing successfully our new unique high pulse energy Thulium fiber laser which should replace traditional Holmium Yag lasers for breaking up kidney stones by enabling much faster and simpler medical procedures. We are also working successfully on other meaningful innovations in dental, aesthetic, hair removal and other medical applications.

Last year we continued with intensive development in complete laser material processing systems for a variety of applications and developed new processing technologies, sophisticated software and hardware solutions. Our focus was mainly on new applications in the fields where lasers are not used up to now. We have achieved very impressive results in some of them. For example we have developed both processes and complete equipment and passed verification

for welding of oil pipes directly at oil drilling stations in the field. Now we are working on a large project for welding large diameter gas pipelines also directly in the field.

Other successful project includes development of technology and complete laser system for welding of large structures of thick titanium or aluminum alloys. We plan to ship the first such unique system to a customer in Q1.

We are continuing investments in sales and production facilities. In Q4, we opened a new office in Wuhan, China and in the Czech Republic. 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. We hope that the new offices in Wuhan and the Czech Republic will help us develop new OEM customers and improve our business with existing customers.

Looking ahead, we continue to be optimistic for 2016 and are managing the company to achieve double digit-growth for the year. Our optimism is grounded in our strong core products, our backlog and many new product introductions planned during the year. Our core fiber laser products will contribute moderately to our 2016 growth. In addition, we expect continued strong growth for some of our recently introduced products. The growth will be enhanced by our rich product pipeline. At this time, most of our OEMS continue to expect to see growth for their applications and systems this year and, for the most part, remain upbeat. Their feedback is not as gloomy as the emotional sentiment in the financial markets.

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

Tim Mammen:

Thank you Valentin and good morning everyone.

Fourth-quarter revenue grew 8% to \$223.6 million from \$207.4 million a year ago. Materials processing sales increased 9% year-over-year to \$209.0 million, accounting for approximately 94% of total sales during the quarter. The lower than traditional growth rate primarily reflects sales decreases in Russia and Turkey and single digit growth in Europe. However, as I will discuss later, North America, China and Japan each had double-digit growth in the quarter. Sales to other markets, including advanced applications, telecom and medical applications, which accounted for approximately 6% of IPG's total revenue, decreased by approximately 11% to \$14.6 million. Strong growth in medical, and to a lesser extent telecom, was more than offset by lower sales in advanced applications, which are typically large and uneven from quarter to quarter. Growth in the medical area was driven by increased demand from core customers in the skin rejuvenation and aesthetic markets. The increase in telecom sales was primarily due to demand for products for last-mile fiber for US cable TV access.

High-power laser sales, which accounted for 55% of total revenue, increased 6% year-over-year to \$122.6 million. This growth was driven by a 10% increase in core materials processing applications including cutting and welding offset by decreases in advanced applications and micro-processing applications.

Pulsed laser sales decreased by 13% year-over-year to \$27.8 million, due to lower year-over-year demand for marking and engraving applications as a result of increased competition and

also pricing pressure in China. We should note that we have been seeing price competition for pulsed lasers moderating in China in recent quarters.

Medium-power laser sales increased 13% year-over-year to \$24.0 million, or 11% of total revenues. This growth continues to be driven by sales for fine-processing and additive manufacturing, which includes laser sintering applications.

Sales of QCW lasers, which are mostly used for fine welding and cutting, increased by 62% year-over-year to \$10.9 million and accounted for 5% of total revenues. QCW lasers are continuing to displace lamp-pumped YAG lasers at an accelerating rate as Valentin mentioned.

Revenue from low-power lasers increased 13% to \$3.6 million due to an increase in medical applications.

Sales of other products, which include amplifiers, diode lasers, green lasers, mid-IR lasers, integrated laser systems and certain components, increased by 64% year-over-year to \$15.7 million, primarily as a result of higher telecom and laser system sales as well as sales related to the laser display project that Valentin mentioned earlier.

Service, parts, lease and other revenue, including accessories, totaled \$19.0 million, an increase of 3% from \$18.5 million last year. This increase includes \$3.8 million of deferred revenue recognized in Q4 2015 compared with \$2.9 million recognized in Q4 2014.

Now looking at our Q4 performance by geography...

Sales in Asia increased to \$111.6 million, or by 14% year-over-year. Within that region, China sales increased 13% to \$69.1 million. Growth in China was primarily related to strong demand for welding and brazing applications using high power and QCW lasers, and solid growth for cutting applications using high and medium power lasers. This growth was partially offset by the decline in sales for marking and engraving applications that I mentioned earlier. In Japan, sales increased 39% year-over-year to \$23.3 million reflecting the continued penetration of cutting OEMs in this geography.

European sales increased 2% year-over-year to \$70.8 million. We saw good growth in Germany, particularly for welding and laser sintering applications. But that growth was partially offset by lower sales in the rest of Western Europe and Russia.

North American sales grew 2% year-over-year to \$39.9 million. In North America we had double digit growth in sales in materials processing applications with particularly good growth in cutting and welding. However growth in materials processing was offset by a decline in advanced applications sales resulting in a more modest overall growth for the US despite a good performance in materials processing.

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

Gross margins of 54.6% were at the high end of our range of 50% to 55% as a result of the good absorption of manufacturing costs due to high levels of production. Some of this was added to inventory during the quarter, mostly in the diode area. Our inventory of diodes was operating with only a few weeks supply on hand. As we have brought on some of the additional chip and packaging capacity we have managed to build about 3 months supply of diodes.

In real dollars, Sales & Marketing expenses increased to \$8.6 million from \$7.9 million a year ago, while they were flat as a percentage of sales at 3.9%. This is an area where we plan to invest in 2016 by expanding in new geographic locations such as the Czech Republic, Mexico and Brazil and hiring new sales specialists to cover some of our new product and application introductions.

Research & Development expenses increased to \$17.8 million from \$13.8 million a year ago. As a percentage of sales, R&D increased to 7.9% from 6.7% 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. R&D continues to focus on improving existing products, 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 decreased to 6.6% of total sales compared with 7.3% one year ago. General & Administrative spending in total dollars decreased to \$14.7 million, from \$15.1 million, a year ago reflecting lower consulting costs and collections of previously reserved accounts receivable.

Operating expenses for the fourth quarter were \$39.0 million, including a foreign exchange gain of \$2.1 million, compared with \$34.3 million a year ago, which included a foreign exchange gain of \$2.6 million.

Fourth-quarter operating income was \$83.0 million, or 37.1% of sales, compared with \$79.6 million, or 38.4% of sales, in the fourth quarter of last year. Excluding foreign exchange, operating margins were 36.2% and 37.2% in 2015 and 2014, respectively.

Our tax rate in the fourth quarter was 26.5%. We had a benefit of \$0.04 per share from the reenactment of the U.S. R&D tax credit, which was signed permanently into law at the end of the fourth quarter as compared to a benefit of \$0.02 per share in Q4 2014 when it was just reenacted for that year. The change should allow for a more consistent effective quarterly tax rate in 2016.

Net income for the fourth quarter increased by 7.6% to \$60.7 million. On a diluted per share basis, we reported \$1.14 for the fourth quarter compared with \$1.07 a year ago. In Q4 2015 the foreign exchange gain increased EPS by \$0.03 while in the same quarter last year it benefited EPS by \$0.04. Excluding the benefit related to foreign exchange transaction gains and the lower effective tax rate during the quarter, EPS was \$1.07 as compared to \$1.01 for Q4 2014.

If exchange rates relative to the U.S. Dollar had been the same as one year ago, which were on average Euro 0.80, Russian Ruble 48, Japanese Yen 115 and Chinese Yuan 6.14, respectively, we would have expected revenue to be \$15.0 million higher, gross profit to be \$7.6 million higher and operating expenses would have been \$2.7 million higher.

Now, turning to the balance sheet...

We continue to maintain a strong balance sheet, ending the year with \$582.5 million in cash and cash equivalents, \$106.6 million in short-term investments, and \$19.7 million of debt.

At December 31, 2015, inventory was \$203.7 million, up 19.1% from \$171.0 million at year end 2014. As I mentioned earlier, we had good absorption of our manufacturing costs and some of

that absorption wound up in inventory. Our current level of inventory on hand amounts to approximately 184 days, compared with our target range of less than 180 days.

Accounts receivable were \$150.5 million at the end of the fourth quarter, or 62 days' sales outstanding, compared with \$143.1 million at December 31, 2014, or 63 days' sales outstanding.

Cash provided by operations during the quarter was \$60.7 million.

Capital expenditures for the quarter totaled \$19.4 million and were \$70.6 million for 2015. This was above the \$60 to \$65 million range we previously provided due to the timing of payments related to a cogeneration electricity plant in Oxford, Massachusetts. We expect capex for full year 2016 to be in the range of \$100million to \$110 million for facilities and equipment to increase our capacity to support our future growth. We intend to seek financing for one or more of the facilities that might reduce cash expenditures to between \$80 and \$90 million.

At the end of Q4, we had backlog of \$442.5 million, a 38% increase from year-end 2014. This included shippable orders of \$185.1 million and frame agreements of \$257.4 million which increased by 6% and 76%, respectively, as compared to year end 2014.

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

As Valentin mentioned, we continue to be optimistic for 2016 and are managing the Company to achieve double digit growth for the year. Our optimism is grounded in our strong core products, our backlog and many new product introductions planned during the year. Further backlog in China up 27% over last year indicates that the demand for our unique and leading products is different than the macro news everyone hears daily about China.

As Valentin discussed, our core fiber laser products will contribute moderately to our 2016 growth. In addition, we expect continued strong growth from some of our recently introduced products including the QCW lasers, high power pulsed lasers as well as the trifocal brazing laser. From an application perspective we expect stronger growth from high power and fine welding applications for automotive and battery welding as well as laser sintering, cleaning and ablation applications, and moderate growth from cutting applications.

The growth will be enhanced by our rich product pipeline. New product introductions for 2016 include new industrial laser systems, laser projection systems, ultra-fast pulsed lasers and UV lasers. In addition, I would like to provide some more color about opening backlog. Japan is up by about 33% year-over-year and, as already mentioned, opening backlog in China is up by approximately 27%. In other locations such as Europe and the U.S.A. it is slightly lower. Our frame order backlog has increased by 76% from \$146 million to \$257 million. In Q4, we reviewed this frame agreement backlog with our customers. While we cannot assert with 100% certainty that this entire frame agreement backlog will result in shippable orders, it supports the forecasts we are receiving from our main OEMs that they still expect to see growth in 2016.

So while the midpoint of Q1 guidance calls for a slower start to the year, we are still targeting double-digit growth with increased sales in subsequent quarters based on several factors. First, a substantial proportion of Japanese backlog is scheduled by customers for Q2 and Q3 delivery. In 2015 a different dynamic was at play. In Q1 2015 Japanese revenue was strong due to the change in Consumption Tax rates that accelerated deliveries into Q1 2015. While we expect Chinese revenue to continue to show growth year-over-year, in Q1 2016 revenue in Europe and

the U.S.A. is flat compared to a year ago. It is positive that order flow in China continues to hold-up nicely while in Europe and the U.S. order flow has started to improve during this quarter.

Obviously the macro-economic environment is more uncertain than a year ago. It could turn more negative during the year which would impact our current expectations. In addition, the growth in revenue from new product introductions is predicated on successfully introducing them to the market, gaining acceptance from end customers, displacing incumbent technologies and finding new applications. In addition our outlook can change due to changes in foreign exchange rates, competition, pricing and the timing and shipment of orders. In short, the risks of the current environment are more difficult to predict than they have been for the last couple of years.

In the meantime, we will manage for long-term growth, including investing in R&D and infrastructure, to take advantage of the historical shift in laser usage that IPG fiber lasers initiated.

We currently expect revenues for the first quarter to be in the range of \$200 million to \$215 million. We anticipate Q1 earnings per diluted share in the range of \$0.88 to \$1.03. The mid-point of this guidance represents quarterly revenue growth of approximately 4% and a relatively flat EPS, respectively, year-over-year. The EPS comparison takes into consideration the foreign exchange gain bottom-line benefit of \$0.11 per share in Q1 2015.

The EPS guidance is based upon 53,434,000 diluted common shares, which includes 52,714,000 basic common shares outstanding and 720,000 potentially dilutive options at December 31, 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 0.92, Russian Ruble, 75 Japanese Yen 120 and Chinese Yuan 6.60, respectively. I want to reiterate that we do not attempt to forecast transaction gains or losses related to changes in exchange rates.

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.