

IPG Photonics Corporation

First Quarter 2010 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' first-quarter fiscal 2010 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 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 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, 2009 and other reports on file with the Securities and Exchange Commission. Copies of these filings may be obtained by visiting the

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Investors section of IPG's website at investor.ipgphotonics.com/sec.cfm or by contacting the Company directly. You may also find copies on the SEC's website at www.SEC.gov.

Any forward-looking statements made on this call are the Company's expectations or predictions only as of today, May 3, 2010. 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. Please go to www.ipgphotonics.com and select "Investors" to review these remarks. I'll now turn the call over to Dr. Gapontsev.

Valentin Gapontsev:

Good morning. And thank you for joining us today.

We are pleased to report that earnings per share are at the high end of our guidance range on revenue that was in-line with guidance for the first quarter of 2010. IPG executed well on its business plan and improved sales and gross margins. We were also pleased that our book to bill ratio was in excess of one and this is reflected in our guidance for the second quarter. In addition we generated \$7.9 million in cash flow from operations.

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Now, I would like to touch on some recent highlights before turning the call over to Tim.

The macroeconomic recovery appears to be underway as we saw improvements in most major geographic markets across the globe.

Much of IPG's first-quarter year-over-year growth was driven by increased sales of IPG's pulsed lasers for materials processing applications, and low-powered lasers for medical applications.

In fact, the materials processing market grew by 23% year-over-year and the medical applications market delivered its second-consecutive quarter of triple-digit year-over-year growth.

On the market front, I am pleased to inform you that the 2009 fiber laser market results from the firm Optech Consulting are in, with associated positive conclusions for fiber lasers and IPG. According to Optech the global fiber laser market decreased last year by 24% from \$317 million in 2008 to \$242 million in 2009 compared to the total global laser market that decreased by 31% from \$7.5 billion in 2008 to \$5.5 billion in 2009.

These results demonstrate increased momentum for fiber laser solutions versus traditional CO₂, YAG and diode lasers in material processing, medical and advanced applications. For our largest market, materials processing, the most recent market data also shows that fiber lasers represented nearly 10% of the material processing laser market in 2009 up from 7% fiber laser penetration in 2008. According to Optech estimates, the overall material processing laser market is predicted to grow by 15% in

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2010. We continue to believe that fiber lasers should grow even faster by playing an increasing role in many key applications and continuing to displace traditional lasers.

In terms of new technology, we recently announced two acquisitions that expand our product portfolio and provide us with an entry into complementary markets.

During the first quarter we acquired Photonics Innovations, an Alabama-based maker of active and passive laser materials and tunable lasers. The technology we acquired with Photonics Innovations enables IPG to expand our portfolio to the middle-infrared spectral range by combining it with our fiber laser technology to build new hybrid laser sources for various applications. These applications include scientific, biomedical, material processing, and eye-safe range-finding. The middle-infrared market is an exciting and emerging space, which we believe represents an attractive opportunity for us to increase market share. The immediate benefit of this acquisition is reflected in the level of inquiries we are receiving from prospective customers for new Zinc Selenide Single Frequency Tunable Lasers.

Subsequent to quarter end, we also acquired Germany-based Cosytronic KG, or COSY. COSY is a specialist in joining technology with an emphasis on engineering know-how in automated welding turnkey solutions. Through this acquisition, we expect to expand our product offerings to include an innovative welding tool laser-seam-stepper that integrates seamlessly with our fiber lasers. We believe this is a promising

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complementary market for IPG targeting the automotive industry, sheet metal production and other material processing applications.

Finally on the new product introductions, our new quasi-pulsed CW lasers have been well received in the market and the first customer recently placed a multiple unit order for these devices. We are optimistic that they will start to contribute meaningfully in the second half of the year. After a rigorous testing process, we have now started to sell green pulsed lasers to customers covering a broad range of microelectronics and solar cell applications. Our high-power cladding lasers are gaining good momentum with customers and we are hopeful that cladding will become a meaningful material processing application going forward.

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

Tim Mammen:

Thank you Valentin and good morning everyone.

It was nice to see the year-on-year improvement in sales in Q1 2010 as Valentin has mentioned. Also significant was that the sales increase drove an improvement in our gross margins, evidencing the leverage in our business model that continues to exist.

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First, I'll begin by taking you through our various markets, products and applications, and then review our income statement and balance sheet.

Materials processing recovered nicely during the quarter, increasing 22.9% on a year-over-year basis and 4.0% on a sequential basis. In total, materials processing, which is IPG's largest market, contributed 83.5%, or \$42.7 million, to the consolidated revenue we reported in Q1. Much of the growth for the materials processing market can be attributed to a substantial improvement in demand for pulsed lasers used in marking and engraving and high-power lasers used in cutting.

The advanced applications market, which includes test & measurement, instrumentation, sensing and defense applications, as well as scientific research & development, represented 9.1% of total revenue, or \$4.7 million, in the first quarter. This was a 34.3% decrease year-over-year and a 31.1% sequential decrease. This is a timing issue as order flow and shipments have been historically less predictable in this market. For example, we have orders in place for several sophisticated 10 kilowatt single mode lasers which will benefit sales when they are shipped later this year. The first quarter of 2009 in addition benefited from the sale of a high value 20 kilowatt laser which makes for a year-over-year comparison that is more difficult.

For the first quarter of 2010, medical sales comprised 3.8% of total revenue, or \$1.9 million. Sales for the medical application market grew by 133.1% on a year-over-year basis, but were down 36.1% from an unusually strong Q4. The year-over-year increase

was due to demand from OEMs worldwide, particularly in the U.S., Korea and Germany, for both cosmetic and surgical applications. During the past few quarters, we have had some success diversifying our customer base and increasing unit sales of low-power lasers for medical applications.

The communications market, which decreased 30.5% year-over-year and 45.3% on a sequential basis, comprised 3.6%, or \$1.9 million, of our total revenues in the first quarter. We had a weak quarter in Russia due to the timing of orders for long haul, broadband access and cable TV and due to the planned merger between long-distance provider Rostelecom with seven regional telecom operators. The merger is delaying orders that we expected to receive in the first quarter. We do expect our Russian telecommunication sales to improve in the second half of the year.

Now, let's look at the business in terms of product lines...

Sales for high power fiber lasers were \$17.5 million, down approximately 3% compared with the same quarter last year and a sequential decrease of approximately 15% from the fourth quarter of 2009. The year-over-year comparison was skewed by a large order for high power lasers for advanced applications, which was delivered in Q1 2009. The sequential decline was due to order timing and seasonality as Q1 is typically our slowest quarter for high-power lasers.

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We had a particularly strong quarter for pulsed lasers with sales of \$17 million. Driven by the improving demand for materials processing applications, particularly marking and engraving, pulsed laser sales grew 30% sequentially and 51% on a year-over-year basis. Our OEM customers in this product line are returning to healthy, pre-crisis levels.

Our low power lasers, which are primarily used for medical applications and micro materials processing, were up 56% year-over-year to \$4.5 million, yet decreased 14% on a sequential basis due to a strong Q4. We expect low power laser sales growth to continue to be strong on a year-over-year basis but sequential sales volumes could vary. Also note that rates of change are calculated from a relatively small base.

Sales of medium power lasers at \$4 million for the quarter were down 24% compared with the first quarter of 2009, and decreased 8% from the sequential fourth quarter. Even though sales in total dollars decreased on a sequential basis, we believe the sales in this product line have stabilized. This is evidenced by a recovery in sales for microelectronics, printing and sintering applications.

From a geographic perspective, our revenue benefitted from an improved macroeconomic environment across the globe.

Asia and Australia made up 39.0% of total revenue. The region's revenues increased on both a year-over-year and sequential basis by 40.6% and 1.6%, respectively. We

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had particularly strong quarters in China and Korea, mostly related to electronics and also general manufacturing OEMs.

In Europe, including Russia and CIS, we reported an increase of 10.8% on a year-over-year basis, or 34.7% of total revenues. On a sequential basis, Europe was down 16.1%, mostly related to a soft quarter in Russia. As I mentioned earlier, the softness in the Russian telecom market is primarily related to order timing and restructuring of the Russian telecom sector. On the other hand, Italy continues to perform well, especially because of its development of several cutting OEMs.

Our North American market grew by 3.8% on a year-over-year basis, amounting to 26.0% of total revenues for the quarter. Sequentially, North American sales were up 9.5%. The year-over-year growth in the U.S. benefitted from increasing sales of low power lasers for medical applications and the sequential improvement was driven by an increase in sales of high power lasers.

The rest of the world made up 0.2% of total sales.

Now turning to the income statement . . .

Total sales were up 12.8% year-over-year to \$51.2 million, within our guidance for the quarter of \$48 million to \$53 million, but down slightly by 5.7% on a sequential basis.

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The fourth quarter is typically our strongest quarter and this was true in 2009. We typically experience a seasonal downward demand trend in the first quarter as compared to the fourth quarter due to budget and spending patterns in some of our major countries, such as Russia, China and Japan. We estimate that if exchange rates had been approximately the same as one year ago, our reported sales would have been \$1.2 million lower in the quarter.

Gross margins were 40.1% in the first quarter, compared with 34.9% in Q1 2009. Benefiting gross margins were 1) the impact of providing for inventory reserves was lower this quarter than in the same quarter of 2009, 2) we benefitted from somewhat better absorption of manufacturing costs and product mix, and 3) a recovery in demand and unit elasticity catching-up with the pricing strategy we started implementing in Q1 2009, as a response to the competitive environment

For the first quarter of 2010, inventory was \$52.1 million, \$0.7 million lower than the year end 2009. If you exclude FX, inventory increased slightly, which will tend to improve absorption of manufacturing costs because we build more product over the same amount of fixed costs.

If exchange rates had been approximately the same as one year ago, our Q1 gross profit of \$20.5 million would have been \$0.3 million lower.

SG&A expenses in Q1 were \$11.2 million, or 21.8% of sales, compared with \$8.2 million, or 18.0% of sales, in Q1 2009. G&A was higher in the quarter as a result of legal expenses related to the increase in activity in the IMRA patent litigation, as well as higher salaries and benefits. In addition, our selling expenses rose due to increases in salaries and benefits and demo unit depreciation. The increase in salaries and benefits for both G&A and selling is largely due to the accrual of bonuses in 2010 because of an improvement in the Company's financial performance, whereas no bonuses were accrued in 2009. We estimate that if exchange rates had been approximately the same as one year ago, our Q1 2010 SG&A expenses would have been \$0.4 million lower.

As we indicated during our previous calls, the IMRA litigation has recommenced. Fact discovery and depositions are complete, but there has yet to be any court action on any substantive matter to date. Due to a recent change in the trial judge, the Markman hearing has been moved to June 2010. The trial is still on track to begin in August 2010. We continue to expect to incur significantly higher legal expenses this year related to this case as we vigorously defend IPG against the claims in this lawsuit.

With respect to the CardioFocus litigation, the district court last week lifted the stay of the litigation. As a result of the patent re-examinations filed, the plaintiff abandoned one patent entirely and the patent office rejected many claims from the two other patents. As we have mentioned in the past, these patents have expired. Consequently, the number of products alleged to infringe has been significantly reduced and is immaterial in our opinion. Activity in this case will increase for the remainder of the year starting in Q2 2010.

R&D expenses were flat with the first quarter of 2009 at \$4.2 million, or 8.1% of total revenues. If exchange rates had been approximately the same as one year ago we estimate that R&D expenses would have been \$0.1 million lower.

Total operating expenses for the first quarter of 2010 were approximately \$15.2 million. We continue to expect quarterly operating expenses to be approximately \$15 million going forward.

In Q1 2010, we had exchange rate gains of \$108,000 compared to losses of \$1.5 million in Q1 '09.

IPG's operating income in the first quarter was \$5.3 million compared with operating income of \$2.0 million in Q1 of last year. Operating income includes stock based compensation charges of \$770,000 and \$635,000 in the first quarters of 2010 and 2009, respectively. In the first quarter of 2010, \$160,000, \$503,000 and \$107,000 of stock-based compensation charges related to cost of sales, SG&A and R&D, respectively.

Our tax rate for the first quarter of 2010 was 32.3%.

Finally, our bottom-line results were at the high end of our guidance range of 2 to 7 cents per diluted share. We reported first quarter net income of \$3.4 million, or 7 cents

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per diluted share, compared with net income of \$1.3 million, or 3 cents per diluted share, for the first quarter a year ago.

Now, turning to the balance sheet...

Our cash and cash equivalents increased by \$1.5 million to \$84.4 million at quarter end. We drew down our credit line by \$1.2 million in the quarter, so cash net of the change in credit line was up slightly. Cash generated from operations was \$7.9 million.

Capital expenditures were \$5.5 million for the first quarter, in line with our expectations. During the quarter, we acquired a building in Korea that will be used for sales and service and expanding our applications center in Korea to add high power fiber laser applications. The purpose of the new application center is to advance our penetration of the Asian automotive, electronics, medical manufacturing and heavy-industry markets.

Looking ahead, we are targeting CapEx for the year to be approximately \$25 million which includes some budget spending for future acquisitions.

Accounts receivable were \$30.1 million at March 31, 2010 compared to \$30.4 million at December 31, 2009. Days' sales outstanding were 53 days at the end of Q1 2010 compared to 50 days at December 31, 2009.

This leads us to our expectations going forward...

We started the year off with a solid quarter during which we executed quite well on our strategy, and we are encouraged by our prospects for the remainder of 2010. Our global sales force is reporting growing activity in customer inquiries and requests for quotations in almost all geographic areas. We continue to see the rate of adoption of fiber lasers in line with our expectations and some stability in pricing. This, coupled with our positive book to bill ratio in the quarter and signs of a general economic recovery provide reason for some optimism for us in the coming quarters.

We are also taking actions to position IPG for longer-term growth and ahead of the competition. We are broadening IPG's suite of innovative fiber laser products through our aggressive product development program and acquisitions such as Photonics Innovation. We are also beginning to expand into complementary markets such as those provided by the acquisition of COSY. As always, we will continue to identify new profitable opportunities to expand our customer base and displace existing laser and other non-laser technologies in a wide range of applications.

Now, let me now provide you with our guidance for Q2....

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For the second quarter, IPG Photonics expects revenues in the range of \$57 million to \$62 million. The Company anticipates earnings per diluted share in the range of \$0.10 to \$0.15. That is based on 47,191,000 diluted common shares, which include 46,098,000 basic common shares outstanding and 1,093,000 potentially dilutive options.

This guidance is subject to the risks we outline in our reports with the SEC, and assumes that the exchange rates remain at present levels. I want to reiterate that we do not attempt to forecast gains or losses related to exchange rates.

And with that, we will open the call for your questions.

After Q&A:**Valentin Gapontsev**

Thank you for joining us today. We plan to continue to make progress in executing on our operational and financial goals during the second quarter of 2010 and we look forward to speaking with you again this summer.