

# **IPG Photonics Corporation**

## **Second Quarter 2009 Conference Call Prepared Remarks**

### **Operator:**

Good morning, and welcome to IPG Photonics' second-quarter 2009 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, 2008 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 at [www.ipgphotonics.com](http://www.ipgphotonics.com) or by contacting the Company directly. You may also find copies on the SEC's website at [www.SEC.gov](http://www.SEC.gov).

Any forward-looking statements made on this call are the Company's expectations or predictions only as of today, August 4, 2009. 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 after the completion of the call. Please go to [www.ipgphotonics.com](http://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.

As you know already our, second quarter revenues of \$40.4 million came in at the low end of our guidance range, down 28 percent year over year. We also reported a loss of \$1.2 million for the quarter, or 3 cents per share. And while we fell short of our bottom-line guidance, we continued to cut expenses and capital expenditures, and we also continued to generate cash. Overall, our financial performance continues to reflect the global economic downturn.

The good news from this quarter is that high power lasers, which are now our most significant contributor to sales, continued to grow on a year-over-year basis. We are seeing growing market acceptance of fiber lasers in high power applications as users continue to move away from traditional lasers and turn to IPG's superior high power sources for cutting, welding, brazing, cladding and other applications. We also continue to see new applications for our high power lasers. Please note that high power lasers for cutting and welding is the largest available market for industrial lasers—much larger than the market opportunity for marking lasers.

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Let me discuss some operational highlights for the quarter:

First, we sold our first pulsed green lasers and we are now accepting customer orders. We have strong customer interest and several units are in customer tests now, including solar. We have also started to ship two other new exciting product families. One of them provides high energy per pulse, up to 50 joules in nanosecond pulses. This unique laser family opens exciting new opportunities in LCD display processing, automotive and other applications.

The second product family is a long pulse fiber laser targeted at replacing lamp pumped YAG lasers. These lasers have pulse durations from hundreds of microseconds and multiple milliseconds, and energy per pulse up to 50 joules. We estimate this market is approximately \$300 million now.

More recently, we announced the successful development of a 10 kilowatt single mode laser, which is a great milestone for IPG and the laser industry in general. We have accepted an order for this unique laser, which has applications for tactical directed energy applications and many others.

Also, we are now offering a 100 watt fiber-coupled laser diode, the most powerful high brightness single-emitter based laser diode. At the lowest cost per Watt, the new diode is well ahead in performance of any existing fiber-coupled laser diodes available in the market.

We are hopeful that these new products can compensate for some of the impact from the global economic downturn.

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Second, I want to highlight that we hired additional experienced sales staff that will solely focus on the merchant market for our best-of-class laser diodes. Also, we now have an additional sales representative in Brazil focusing on high power and the automotive market there. We have added skilled sales personnel in China, as well as other locations internationally.

Third, we completed the purchase of the remaining 20 percent minority interest in our Japanese subsidiary, further simplifying our structure.

In total, IPG's value proposition remains strong. Customers continue to choose IPG's fiber lasers for their superior performance, reliability, usability and lower total cost of ownership compared with conventional lasers. We are taking the right actions to ensure that we are an even stronger company when our markets rebound. Our continued investment in sales infrastructure and our aggressive product development strategy will allow us to maintain our technological edge and leadership position. We expect to be well positioned for renewed growth when the global economy recovers.

I will now turn the call over to our CFO, Tim Mammen for details.

### **Tim Mammen:**

Thank you Valentin. Good morning everyone.

I want to provide an overview on financial results before I review our markets and business lines.

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As Valentin mentioned, we reported a net loss of \$1.2 million, or \$0.03 per share, in line with our announcement on July the 23<sup>rd</sup>, but below our original guidance range. Our Q2 earnings were lower than expected for three primary reasons. First, we had lower absorption of fixed costs due to lower sales volumes and a reduction in the level of inventory during the period. Second, we experienced pricing pressure for our high power and pulsed lasers because of the macro-economic and competitive market. We expect pricing for kilowatt lasers to stabilize at current demand levels. Third, we increased R&D expenses in the quarter in order to get new products ready for production and to accelerate the development of other products and product enhancements.

Now, I'd like to provide a brief update on our cost-reduction initiatives.

In the second quarter we reduced expenses by \$1.5 million compared to the average quarterly expenses for 2008. These reductions are due to lower bonus accruals, short work-week programs, workforce reductions and other expense savings. We have also reduced general and administrative expenses such as legal, accounting and consulting. However, some of these cost savings have been offset by lower absorption of fixed costs and an increase in certain R&D expenses as I mentioned above. While we have reduced our cost structure, we will continue to review the business in order to identify other potential expense reductions and, in particular, to track how the remainder of the year is trending in terms of any potential recovery in sales volume. Also, because many of our cost reductions, such as reduced work weeks, are temporary in nature, we will continue to evaluate whether more permanent changes to our cost structure may be necessary.

**Now let's take a look at the four markets we serve . . .**

Materials processing, which is IPG's largest market, contributed 74.3 percent, or \$30 million, of the total revenue we reported in Q2, down 36 percent year-over-year. As Valentin mentioned earlier, the vast majority of this decline stems from significant order reductions for our pulsed laser business, which began slowing in the third quarter of 2008. The decline was primarily related to marking and engraving applications. After a slight uptick in business for pulsed laser sales for solar applications during Q1, solar sales were slightly weaker in Q2, sequentially and year-on-year, as we continue to wait for several projects to restart. In Q2, we also saw a reduction in sales of our medium power lasers, although this is compared to high sales volume in Q2 2008.

The advanced applications market, which includes test & measurement, instrumentation, sensing and defense applications, as well as scientific research & development, represented 14.1 percent of total revenue, or \$5.7 million, during the second quarter. Sales of these laser systems were relatively stable, growing modestly by 2 percent compared with the prior year.

The communications market, which comprised 7 percent, or \$2.8 million, of our total revenues in the second quarter, increased by about 10 percent compared with the second quarter of 2008. The increase was driven by sales in Russia, where we recently became qualified as a Tier 1 supplier to several Russian telecom providers, including the largest one. These qualifications present large opportunities for us as Russian optical network spending is robust.

Sales for the medical application market comprised 4.7 percent of revenue, or \$1.9 million, compared with \$940 thousand in the second quarter of 2008, an increase of

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more than 100 percent year over year. We've been discussing our efforts to diversify our customer base in this segment for several quarters now, and we are now seeing some real success as we win OEM orders from the competition. In addition to orders from new customers in Korea and China, we are also seeing opportunities in the U.S. Although still a relatively small component of our total sales, we expect the recovery in this market to continue.

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

Sales of our high power fiber lasers increased by 16 percent year-over-year in Q2 to \$15.6 million and represented 38.6 percent of total revenue. The total kilowatts of output power shipped increased by 42.3 percent in Q2 09. Sales for high power were down sequentially from Q1 09. The demand we're seeing for high power lasers continues to be for cutting, welding and cladding applications.

Right now we're seeing increasing interest from automakers to qualify our high power lasers for welding aluminum parts in automotive industry applications. And we are expecting to receive additional orders to be used in electric battery welding in the second half of the year.

In terms of new applications, during the quarter we shipped a 20kW laser for leading edge research in the energy sector. We also shipped a 4 kW laser for a magnet scribing application.

As mentioned previously, pricing pressure for high power and pulsed lasers affected our Q2 gross margins. However, even now, fiber lasers are competitive with CO2 lasers on

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an upfront cost basis, and offer an even lower total cost of ownership proposition when you factor in the lower operating costs. At these demand levels, we expect pricing on kilowatt lasers to stabilize.

When we look at the numbers, and see the growing number of OEM cutting customers, we are increasing market share in high power materials processing applications during difficult economic times and positioning the company to be in a good position when higher levels of capital expenditures occur. What is meaningful is that high power laser markets represent a substantially larger market opportunity with fewer competitors than pulsed laser markets. It was estimated that in 2008, revenues for all lasers for high power materials processing was \$950 million compared to \$201 million for marking and engraving. About 75% of the high power materials processing market was for cutting lasers. The dollar figures would be lower for 2009 given where the world economy is today, but we feel there is a silver lining in our report to be taken from the growing penetration of fiber lasers in high power laser applications.

As I mentioned earlier, sales of pulsed lasers significantly declined. For Q2 09, pulsed lasers were down 55 percent year over year to \$9.9 million, representing 25 percent of revenue. The year-over-year decline was driven from our OEM marking customers who are experiencing reduced demand in their end markets. We are seeing some pricing pressure for our pulsed lasers as well, but mostly on the lower end. We remain confident that we are not losing market share in pulsed lasers and that the quality of our products and the relationships we have with our major OEM customers will position us for growth when the market rebounds.

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Sales of medium power lasers decreased 54 percent in Q2 of 2009 from Q2 of 2008, and represented 11 percent, or \$4.3 million, of total revenue. Much of the weakness stems from the weak economic conditions, including low demand from microelectronics drilling, commercial printing and micro-materials processing applications. We do not believe that drop is due to loss of market share or customers. It should also be noted that Q2 and Q3 of 2008 were strong quarters for sales of medium power lasers as new customers came on line.

Our low power lasers, which are primarily used for medical applications and micro materials processing, were down 35 percent year over year and accounted for 7 percent of revenue, or \$2.8 million, in Q2 2009. Low power lasers are stabilizing because of the recovery we're seeing in our medical business.

From a geographic perspective, we reported 37.5 percent of revenue from Europe, 32.6 percent from Asia and Australia, and 29.8 percent from North America. Our sales in North America appear to have been least affected by the global economic downturn, reporting only an 8 percent sales decline. In North America we continued to see resilience from traditional material processing applications, such as cutting and welding in general industries as well as demand for new applications such as battery welding and drilling. This suggests that our high power fiber lasers are gaining in terms of market adoption versus traditional lasers.

Europe was down 33 percent with Germany contributing a majority of the decline due to lower sales from marking, solar, and printing applications. Asia and Australian markets declined 30 percent compared with the second quarter a year ago. Pulsed laser sales

in Japan were particularly weak, while Korea had a good quarter due to strong medical orders.

Although still down year over year, Q2 sales in China marked an increase in quarterly sales compared to the previous two quarters, driven by marking and cutting sales to some large laser systems manufacturing OEMs. As we mentioned last quarter, our new general manager in China is aggressively targeting large OEMs and end users for traditional and new materials processing applications including high power applications.

### **Turning now to the income statement . . .**

Sales for the quarter were down 28 percent year-over-year to \$40.4 million. We estimate that if exchange rates had been approximately the same as one year ago, our Q2 sales would have been \$2.0 million higher.

Gross margins were 29.1 percent in the second quarter of 2009, compared with 48.1 percent in Q2 '08. Gross margin was negatively affected by lower absorption of manufacturing costs due to lower sales volumes and reductions in inventory levels, product mix (due to lower sales of medium power lasers) and the impact of pricing pressures on average sales prices, particularly for pulsed lasers and certain high power lasers. In addition, despite our cost reduction programs, which reduced costs in absolute dollar terms, manufacturing costs were higher as a percentage of sales than those of Q2 2008. Inventory write-downs totaled \$1.4 million for the second quarter of 2009. We estimate that if exchange rates had been approximately the same as one year ago, our Q2 gross profit would have been \$1.4 million higher.

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SG&A expenses, excluding foreign exchange losses, were \$8.6 million, or 21 percent of sales in Q2 2009, compared with \$9.4 million, or 17 percent of sales, in Q2 2008. The reduction in SG&A expenses were primarily due to reduced costs for salaries and benefits as well as lower legal, accounting and consulting fees. We estimate that if exchange rates had been approximately the same one year ago, our Q2 09 SG&A expenses would have been \$0.3 million higher in Q2 09 although still lower than Q2 2008.

I want to update you on recent activity in the lawsuit involving IMRA America. In July, the United States Patent and Trademark Office confirmed the patentability of all of the claims in the IMRA America patent over the prior art cited in the re-examination, as well as of new claims added during the re-examination. The federal court in Michigan previously stayed the litigation until the conclusion of the re-examination. As a result, we expect to incur higher legal expenses in the coming quarters after the stay is lifted and litigation resumes. At this stage, we do not have more information on timing. As we have stated in our 10-Ks and 10-Qs, we have defenses in the lawsuit that we will pursue when the litigation starts again. The CardioFocus patents remain in re-examination at the Patent and Trademark Office.

R&D expenses were \$4.7 million, or 12 percent of revenues in Q2 2009. This compares with \$4.4 million, or 8 percent of revenues, in the second quarter of 2008. The real dollar increase in R&D is driven by our push to get certain new products ready for production.

In Q2 09 exchange rate gain on transactions and the revaluation of financial assets and liabilities were \$0.5 million compared to a loss of \$0.3 million in Q2 08.

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IPG's operating loss in the second quarter of 2009 was \$1.3 million compared with operating income of \$12.8 million in Q2 of last year. Operating income includes stock based compensation related charges of \$569,000 and \$617,000 in the second quarters of 2009 and 2008, respectively. In the second quarter of 2009, \$126,000, \$436,000 and \$7,000 of stock-based compensation charges related to cost of sales, SG&A and R&D, respectively.

Our tax rate for the second quarter of 2009 was 31 percent. We estimate an overall tax rate of 31 percent for the year. The effective rate for 2008 was 32 percent.

Our second quarter net loss attributable to IPG was \$1.2 million, or \$0.03 per share, compared with net income of \$8.6 million, or \$0.19 per diluted share, for the second quarter a year ago.

Year-to-date cash generated from operations has exceeded the amount spent on investing activities by more than \$16.0 million.

In the second quarter we reduced capital expenditures to \$3.0 million and in total \$7.8 million for the year to date.

As a result of these actions, our cash and cash equivalents net of debt have increased to \$28 million, compared with \$12.2 million at December the 31<sup>st</sup>, 2008. Cash and cash equivalents improved from year end by \$26.8 million to \$78.1 million at the end of the quarter. Not included in cash and cash equivalents are \$1.3 million in auction rate securities at June 30, 2009, which are included in other long-term assets.

In Q3, we will use some of the cash built up during the year to pay down part of our revolving credit lines. Going forward, we intend to target gross cash on the balance

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sheet of between \$55 and \$65 million and use any cash on hand in excess of that amount to reduce short-term debt.

Cash flow from operations in the second quarter was \$6.3 million. Cash used in investing activities was \$3.1 million and cash provided by financing activities was \$1.6 million. At current business levels, we are still targeting capital expenditures to be less than \$15 million for the year.

Accounts receivable decreased to \$32.0 million at June 30, 2009 from \$41.8 million at December 31, 2008. Days sales outstanding were 71 days at the end of Q2 compared to 65 days at the end of 2008. The increase primarily reflects the timing of shipments during the quarter and to a lesser extent some longer payment terms for certain customers.

Finally on the balance sheet, inventory decreased by \$10.4 million to \$62.1 million at June 30, 2009 from \$72.6 million at the year-end 2008.

### **This leads us to our expectations going forward...**

Visibility remains limited for most of the markets we serve, although it is better in Q3 than it was at the equivalent point in Q2. While we are hopeful for a modest recovery in the second half of 2009, we expect that the weakness in the materials processing market may limit meaningful improvement in our revenue and net income for the remainder of 2009. We also expect that we will continue to experience pricing pressure for the foreseeable future.

However, there are some bright spots. We expect continued resilience in demand for high power lasers which we believe to be a result of increasing market share and the enabling of new applications at higher powers. Moreover, we are seeing some strength in the medical, telecom and advanced applications markets. We expect the recoveries in those markets to continue gradually throughout the year.

**Let me now provide you with our guidance....**

For the third quarter, IPG Photonics expects revenues in the range of \$39 million to \$44 million. The Company anticipates earnings per share in the range of a loss of (\$0.02) to a profit of \$0.03. That is based on 46,518,000 diluted common shares, which include 45,431,000 basic common shares outstanding and 1,087,000 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.

Before I close, let me also reiterate that we are optimistic about the long-term prospects for IPG. With every challenge there comes opportunity. While the global recession is having a negative effect on our sales and net income for the near-term, we are taking strategic actions to position IPG for strong growth when our markets recover. Our employees are making extraordinary efforts as we continue to offer a compelling value proposition for our customers. With our growing penetration in high power, a large market, strong focus on R&D, our technological edge, a strong balance sheet, and our

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solid infrastructure, IPG will continue to capitalize on the opportunities available to us despite current economic and financial crisis.

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

**After the close of the 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 half of 2009. Moreover, we expect the strategic decisions that we have made internally and externally should help ensure that IPG is able to capitalize on our growth opportunities. We look forward to speaking with you again following the third quarter.