

IPG Photonics Corporation

First Quarter 2009 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' first-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

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Investors section of IPG's website at www.ipgphotonics.com 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 5, 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 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.

Our first-quarter performance reflects the impact of the global economic downturn. Revenues at \$45.4 million came within the low end of our guidance, and were down 14 percent on a year-over-year basis. The decline was mainly due to lower sales of our pulsed lasers, our second largest product line, which are primarily used for marking and solar manufacturing. As you know, marking and engraving applications have been significantly affected by the downturn while our solar manufacturing sales are volatile from quarter to quarter. However, there is good news, our high power fiber laser sales increased over last year. We increased revenue by 18 percent and the total output power of lasers we sold increased by more than 35 percent. The growth in high power fiber lasers now makes this our largest product line and represents our largest market opportunity.

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We observed an essential sales growth in medical and government sectors also, as well as bright signs for fast growth beginning in telecom applications. Geographically, the downturn was large in Central Europe and China. However we saved our positions practically in Japan and Russia and we increased sales in North America, Italy and Korea, essentially.

Regarding EPS, IPG reported its tenth consecutive profitable quarter. However earnings dropped down to \$0.03 per diluted share this quarter, compared with \$0.18 per diluted share in the first quarter last year. In addition to the effect from the fall-off in revenues, the EPS decline reflected much more than usual inventory write-downs, a swing in foreign exchange, and some bad debt expense.

Further, I am pleased to report the good news that we've strengthened our balance sheet including generating a record \$17.5 million in operating cash flow. As a result, our net cash position increased by \$10.7 million to \$22.8 million.

During the first quarter, we have developed and have started to implement a very efficient economic crisis response program which includes, from one side, reducing costs, working capital and capital expenditures to remain profitable and generate cash through the downturn. And, from the other side, an acceleration of the development and introduction to the market of an impressive collection of new unique products to, as a minimum, compensate the sales losses we found with some of our standard products, like pulsed marking lasers. The major elements of the cost cutting program include the following:

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The first is an essential decrease of manufacturing cost of our major products. At the high power end, we will benefit 10 to 20 percent due to the use of new, more powerful pump diodes and 15 to 30 percent due to the introduction of our own processing cables (starting from Q1), couplers (in Q2), optical switches (in Q2), optical heads (in Q3), and chillers (in Q1). Before the accessories of our kW lasers, we were buying from outsources.

During Q1, we have decreased the cost of our low power lasers, including pulsed lasers, by 15 to 20 percent also. In total, these elements will provide IPG multimillion dollar savings.

The second element of savings is cutting the 2009 bonus program and the transfer to a short week for about one third of IPG employees. There is also essential savings we will reach by cutting our accounting, legal, shipment, IT and other expenses.

We have started the saving program in Q1, however the benefit would be seen later, mainly in Q2 to Q4.

Regarding another segment of economic crisis program, i.e. new products, we have to report a very impressive portfolio, which we have developed during the last quarters, or we are finishing now. The main horses of the portfolio include:

- 1 - Pulsed green lasers. We have reported on the product in January. During Q1 we have made a qualification and in Q2, the first 25 units will be delivered to application labs and most important, OEMs for test. We have found a big interest in the product for solar, marking, semiconductor, and micromachining industries.

2 - Nano-pulsed fiber lasers with energy per pulse up to 100mJ and average power up to 1kW. The unique family has been delivered to Audi and a couple of other customers. They are very perspective for the LCD industry also.

3 – Cladding lasers with power up to 4kW. We are starting deliveries in Q2. They will replace direct diode multiKW systems as more reliable, universal, flexible and cost effective.

4 – Single frequency CW green lasers. Will be implemented on the market in Q3. They will replace YAG lasers in Ti Sapphire pumping and open new opportunities in solar and micromachining.

5 – New family of long pulse high power fiber lasers. These will be implemented in Q3 and will start to replace lamp pumped pulsed solid state lasers in applications with an estimated market size above \$100m.

6 - New family of Radio Frequency over PON systems, based on IPG's unique 2-way EDFAs for Fiber to the Home applications.

7 – New high power DWDM EDFAs for cable TV transmitters, based on new unique 2W power 980 SM pumps, developed by IPG. This is a new record of output power from 980 pumps.

8 – Some other products, including powerful red lasers and a set of direct diode modules with a power from 50 to 1000W.

The products should compensate above mentioned losses and position IPG for renewed growth when the economy begins to recover.

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Although it is too early to say that we have turned the corner, our sales force is beginning to report increased customer activity in some of our hardest-hit markets. Tim will provide additional details on some of the bright spots that we're seeing for the second half of the year.

Our fiber lasers provide customers with a value add unmatched by our competitors. As you move up in the power spectrum, more productivity is gained and new applications are possible. This is attractive to customers, particularly as they are looking, now more than ever, for ways to be more efficient with less energy requirements.

Our diversity in terms of end-use applications, product lines and geographic markets adds stability to our business model. I will now turn the call over to Tim Mammen who will discuss the first quarter in more detail and then provide guidance for the second quarter of 2009.

Tim Mammen:

Thank you Valentin. Good morning everyone.

While sales decreased compared to a year ago, our performance by end market and laser type was, in fact, mixed. Sales of pulsed lasers declined substantially, but high power laser sales increased. The decrease in pulsed lasers accounted for all of the decline in our materials processing sales. Excluding the decline in pulsed laser sales, materials processing sales increased 2 percent. Sales of applications other than materials processing grew by 22 percent. Last quarter we announced new initiatives intended to control costs, manage working capital and substantially reduce capital

expenditures. Most of these were implemented during the quarter and should have greater effect on our bottom line during the second quarter.

At the same time, we have continued to invest in IPG's future growth. We commissioned a new high power applications center in Oxford, MA and opened a new sales and applications center in Silicon Valley. This applications center will focus on micro applications, solar and merchant diode sales. We also continue to commit R&D dollars to our product pipeline. Our strategy for 2009 is to ensure that IPG weathers the storm and is positioned for further growth when the economy recovers.

We also maintained our conservative capital structure and continued to generate cash this quarter, strengthening our liquidity and balance sheet. Cash and cash equivalents improved by \$20.3 million to \$71.6 million.

From a revenue perspective, we met the low end of our guidance range for the first quarter at \$45.4 million, compared with \$52.9 million in Q1 2008. Gross margins for Q1 were 35 percent, a lower number than expected as a result of \$2.7 million (or 6 percent of revenues) in inventory write-downs.

Net income for the quarter was \$1.3 million, or \$0.03 per diluted share, which was below the low end of our guidance range. This compares with net income of \$8.1 million, or \$0.18 per diluted share, for the first quarter last year. As Valentin mentioned, in addition to the \$2.7 million in inventory write-downs that affected cost of sales, our bottom line was impacted by \$1.5 million in foreign exchange losses and \$0.4 million for bad debt. Together these items reduced net income by \$3.2 million after tax, or \$0.07 per diluted share this quarter. In the first quarter of 2008, we had inventory write-downs

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of \$0.7 million, foreign exchange gains of \$0.6 million and bad debt expense of \$0.1 million. Together these items netted out and did not affect net income in the first quarter of 2008.

Looking at the competitive landscape, the weakness in customer demand is leading to some pricing pressures for high-power lasers in materials processing applications below 4-kilowatt. But this is case-by-case. There is less competition from legacy laser technology above this power band. Despite claims from competitors, we still have not encountered fiber laser competition at 1-kilowatt or above.

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

Materials processing, which is IPG's largest market, contributed 76.6 percent, or \$34.8 million, of the revenue we reported in Q1, down 21 percent year over year.

Substantially all of the decline in this application resulted from lower sales of pulsed lasers. Orders for pulsed lasers began slowing in the third quarter of 2008, particularly from large customers in China and other Asian countries for marking and engraving. Pulsed laser sales for solar applications have been more mixed with some weakness in North America off set in Q1 2009 by a substantial order for a solar application in Japan, part of which shipped during the quarter. The overall decline in pulsed laser sales, particularly for making and engraving, continued in Q1 2009. Overall sales for solar applications actually increased compared to a year ago. As Valentin mentioned, excluding the decline in pulsed lasers, the materials processing market grew slightly.

The advanced applications market represented 15.7 percent of total revenue, or \$7.1 million, during the first quarter. Sales of these laser systems grew by 34.7 percent

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compared with the prior year. Advanced applications include test & measurement, instrumentation, sensing and defense applications as well as scientific research & development. During Q1 we leased a 50-kilowatt laser to a major defense contractor as part of a rent-to-buy agreement. Although order flow has been historically less predictable in this market, we have significant interest for advanced applications that may benefit the second half of 2009.

The communications market comprised 5.9 percent, or \$2.7 million, of our revenues in the first quarter and declined by 9.0 percent from the first quarter of 2008. However, our sales force is optimistic about Russian and U.S. telecom sales in the second half of the year. We are already seeing early interest in some of the products that IPG introduced last year and in Q1. This includes the two-way EDFA, which enables a cost effective deployment of triple play Fiber-to-the-Home and RF over glass networks. We are also optimistic about additional opportunities as a result of government initiatives and a growing OEM and integrator customer base.

Sales for the medical application market comprised 1.8 percent of revenue and were up 78.4 percent year over year, with Q1 2008 being the quarter in which sales to our main medical OEM materially declined. Our outlook for the medical business has improved because of better visibility from two of our OEMs in North America, a new contract we have signed with a customer in Korea and new opportunities elsewhere in Asia.

Now, let's look at the business in terms of product lines. Sales of our high power fiber lasers grew by 18 percent year-over-year in Q1 to \$18 million, representing 40 percent of total revenue. The total kilowatts of output power shipped increased by 35.6 percent in Q1 09. We continue to see increasing demand for cutting, welding and cladding

applications which all grew strongly in the quarter. In Germany, there is increasing interest from automotive OEMs and end-users, especially for brazing applications. We also have a German automaker qualifying our high-power lasers for gear-box and remote welding. In terms of new applications, we have had several shipments for our multi-kilowatt lasers from companies manufacturing wind turbine blades, towers and other parts. There is also increasing interest from many OEM's around the world in the hybrid battery industry.

As expected, sales of pulsed lasers have continued the decline we began to see in the fourth quarter of 2008. For the first quarter, pulsed laser sales were down 46 percent year over year to \$11.2 million, representing 25 percent of revenue. We expect a sequential decline in Q2 2009 for pulsed laser sales. Our pulsed laser sales have been greatly impacted in Q1 2009 by limited expansion of manufacturing capacity. This has had a significant effect on the business of our three largest OEM's. However, our long term relationships with these OEMs leave us well positioned when capacity expansion resumes. On a positive note, however, solar applications sales increased slightly in Q1 09 and it appears our customers are starting to look at additional build outs in solar in the second half of 2009. However, sales for solar applications will be weaker in Q2 2009 than one year ago. With regard to our recently launched green pulsed lasers, customer tests for solar applications with the new lasers have yielded excellent results. We look forward to reporting further progress as 2009 unfolds.

Sales of medium power lasers decreased 7 percent in Q1 of 2009 from Q1 of 2008, and represented 12 percent, or \$5.4 million, of total revenue. Areas that once saw significant demand, such as microelectronics drilling and commercial printing have been

very slow. For some applications, including sintering and micro materials processing, while orders are lower, relatively speaking, those business are more stable.

Our low power lasers, which are primarily for medical applications and micro materials processing, were down 21 percent and accounted for 6 percent of revenue, or \$2.9 million, in Q1 2009. We will continue to target new OEMs, particularly overseas, where we see opportunities to capture additional sales.

From a geographic perspective, we reported 35 percent of revenue from Europe, 31 percent from Asia and Australia, 28 percent from North America and 5 percent from the Rest of the World.

Sales and order flow in North America was good, and year-over-year sales were up 39 percent for the first quarter of 2009. Despite a difficult capital equipment sales environment in the U.S., we saw strength from typical material processing applications as well as new applications including hybrid battery welding and wind turbines.

Europe was down 33 percent in Q1 compared with the same period last year. Germany was particularly weak, mostly related to decreased sales for marking, welding and printing applications.

Sales to Asian and Australian markets declined 27 percent compared with the year-ago quarter. Order flow in Japan started strong at the beginning of the quarter, but then tailed off as the global economy continued to deteriorate. On a positive note, we have shipped our first high power lasers in China. Our recently hired high power laser sales director for China is aggressively targeting large OEMs and end users for traditional and new materials processing applications.

Turning now to the income statement . . .

We estimate that if exchange rates had been approximately the same as one year ago our Q1 09 sales would have been \$2.1 million higher.

Gross margins were 35 percent in the first quarter compared with 46 percent in the first quarter of 2008. Inventory-related items amounted to \$2.7 million, or 6 percent of revenue – significantly affecting gross margin and our EPS. These related to write-downs of older inventory cost revaluations and obsolescence of certain components.

Historically, such charges have been absorbed within cost of goods sold without having a material effect on gross margin. However the impact in a period of declining sales is magnified.

We estimate that if exchange rates had been approximately the same as one year ago our Q1 09 gross profit would have been \$0.5 million higher.

SG&A expenses excluding foreign exchange losses were \$8.2 million, or 18 percent of sales in Q1 2009, compared with \$9.6 million, or 18 percent of sales, in Q1 2008. We estimate that if exchange rates had been approximately the same as one year ago our Q1 09 SG&A expenses would have been \$0.6 million higher.

R&D expenses were \$4.1 million, or 9 percent of revenues in Q1 2009. This compares with \$2.9 million, or 5 percent of revenues, in the first quarter of 2008. The increase is consistent with our strategy to strengthen our product offerings in anticipation of a recovery in demand. Investment in R&D is across a number of different areas including development a new generation of diode chip and high power laser diode package with better performance and lower cost, new products operating at different wavelengths (for

example the green laser), high energy pulsed lasers and high power laser accessories such as chillers, cables, combiners, beam switches and optical heads. We estimate that if exchange rates had been approximately the same as one year ago our Q1 09 R&D expenses would have been \$0.4 million higher.

In addition to the inventory write-downs, foreign exchange and an increase in our bad debt reserve also affected our performance in the quarter. In Q1 09 exchange rates losses on transactions and the revaluation of financial assets and liabilities were \$1.5 million compared to a *gain* of \$0.6 million in Q1 08. About \$1 million of the impact can be attributed to the depreciation in the Russian Ruble during Q1 09.

Although we reduced receivables by \$12.1 million and improved our days sales outstanding in Q1, we increased our bad debt reserve by \$0.4 million or 1.0 percent of revenue in response to a few customer accounts past due. The amount of accounts receivable greater than sixty days past due not covered by export insurance or bad debt reserve was 1 percent of total accounts receivable. Historically we have demonstrated the ability to ultimately collect a good percentage of the amounts that we have previously reserved and we are continuing to vigorously pursue the amounts we provided for this quarter.

IPG generated operating income of \$2.0 million, or 4 percent of revenue, in the first quarter of 2009, compared with operating income of \$12.5 million, or 24 percent of revenue, in Q1 last year. Operating income includes stock based compensation related charges of \$635,000 and \$387,000 in the first quarters of 2009 and 2008, respectively. In the first quarter of 2009, \$124,000, \$389,000 and \$122,000 of stock-based compensation charges related to cost of sales, SG&A and R&D, respectively.

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Our tax rate for the first 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.

As Valentin mentioned in his opening remarks, we are pleased with our efforts to strengthen our balance sheet during the quarter. Cash and cash equivalents improved by \$20.3 million to \$71.6 million at quarter end. Net cash increased to \$22.9 million at March 31, 2009, compared with \$12.2 million at December 31, 2008.

Not included in cash and cash equivalents are \$1.3 million in auction rate securities at March 31, 2009 which are included in other long-term assets.

Cash flow from operations in the first quarter was \$17.5 million. Cash used in investing activities was \$4.7 million and cash provided by financing activities was \$9.6 million.

We intend to manage the business and working capital so that we generate cash flow from operations that is greater than capital expenditures for the remainder of the year.

At current business levels, we are now targeting capital expenditures to be less than the \$15 million estimate we provided on our year-end call.

After the close of the quarter, we completed construction of an applications center in Italy, which opened in early April. This facility will serve IPG's cutting applications customers in that region. We also opened an expanded application and production facility in Massachusetts and a sales and applications office in California focused on low power applications.

In Q1 2009, we completed the previously announced acquisition of the non-controlling interests in our Russian subsidiary.

Although managing receivables becomes more challenging in a turbulent economic environment, accounts receivable decreased to \$29.7 million at March 31, 2009 from \$41.9 million at December 31, 2008. Days' sales outstanding were 59 days at the end of Q1 down from 65 days at the end of Q4 2008.

Aside from the inventory write-downs, we made progress in reducing inventory this quarter by consuming it. Inventory decreased by \$6.2 million to \$66.4 million at March 31, 2009 from \$72.6 million at year end 2008: of this decrease \$2.7 million related to write-downs and other adjustments to inventory, approximately \$2.6 million related to foreign exchange and \$0.9 million related to inventory that was consumed.

We strategically drew down \$10 million from our U.S. credit facility during the quarter, increasing our borrowings to \$29.8 million. We invested this \$10 million in U.S. Treasuries and increased our cash and cash equivalents. We will continue to draw on our credit facilities from time to time, in order to finance our short-term working capital requirements and preserve and enhance our liquidity.

This leads us to our expectations and plans going forward.

We are committed to remaining profitable for the full year 2009 and beyond, despite the weak economy, uncertain demand conditions and volatility in foreign exchange rates.

As previously disclosed, we have taken action to reduce bonus accruals, limit overtime and reduce other expenses such as legal, accounting and consulting, and we are looking for further opportunities to cut costs. We expect the full year effect of these reductions to be more than \$3.5 million. In addition, beginning at the end of Q1 2009, we have instituted reduced work weeks in Germany and Russia. We should see the

benefit of these actions increase in the second quarter. We also have reduced spending on manufacturing supplies and tooling and have reduced the number of diodes undergoing burn-in testing to reduce electrical consumption. In total we expect the combined benefit related to the reduction of operating expenses and manufacturing expenses to be in the upper end of the range of \$4 to \$6 million for 2009 we targeted on our previous call.

We have also begun internal production of cables, couplers, beam switches and optical heads which will increase the profitability of these items. Historically, our margin on these items has been much lower than the gross margin on our lasers because we purchased them from outside suppliers and we only earned a pass-through margin. As our high power laser sales continue to grow, the benefit related to the accessories should increase to several million dollars per year starting in 2010.

One positive sign is that our global sales force is reporting more customer inquiries and requests for quotations. That said, there is a sales cycle involved and it will take a few months for new orders to materialize and visibility remains weak. So we're hopeful that the second half of the year will be better than the first. In the meantime, we will continue to pursue all available options for strengthening our balance sheet and our competitive position. IPG is well-prepared when the economy returns to growth.

These are indeed challenging times, even for IPG which has proven to its customers that its products provide significant advantages over competing lasers and other technologies. But I want to add some perspective: an industry analyst estimates that fiber lasers accounted for only 7 percent or \$210 million of the total laser market for materials processing estimated at \$3.0 billion in 2008. The same analyst expects that

the market potential for fiber lasers in 2015 could be over 30 percent for high power welding, cutting and marking, three large applications for industrial lasers. Historically, laser sales have grown at a compounded annual growth rates over 5 percent. We feel that fiber lasers, which offer a compelling value proposition, are at an early stage of adoption in high volume applications like high power welding and cutting. I cannot predict the future, but I can say that given the strength in our high-power sales in Q1 and our improving balance sheet, we will be well-poised to benefit from the groundwork we have laid over the last few years when demand conditions improve. With that as background, I'll provide you with our guidance for the second quarter.

For the second quarter, IPG Photonics expects revenues in the range of \$39 million to \$45 million. The Company anticipates earnings per diluted share in the range of \$0.01 to \$0.07. That is based on 46,152,000 diluted common shares, which include 45,094,000 basic common shares outstanding and 1,058,000 potentially dilutive options. At this level of revenue, a \$1 million increase or decrease in revenue will change gross profit by approximately \$750,000 given our fixed manufacturing cost base and rates of absorption. At \$45 million of revenue, we would expect gross margins of approximately 41 percent.

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. As evidenced by Q1 09 if exchange rates are volatile their impact on results can be material.

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

After the close of the Q&A:

Valentin Gapontsev:

Thank you for your time and questions this morning. We continue to believe that our fiber lasers offer customers the chance to create new and improved applications where lasers have never been used or traditional lasers were once the norm. We expect to further expand our position in the laser market worldwide, even during this challenging economy. Our diverse suite of products will continue to evolve with our customers' needs in order to improve productivity.

Thank you everyone for joining us today. We look forward to speaking with you again following the second quarter.