

IPG Photonics Corporation

Third Quarter 2009 Conference Call Prepared Remarks

Operator:

Good morning, and welcome to IPG Photonics' third-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 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, November 3, 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.

IPG delivered a solid quarter compared with the expectations that we set back in August, given the challenging business environment. We exceeded our guidance for revenues as well as EPS. Third-quarter revenues were \$45.8 million, down approximately 26 percent year over year, and up 13 percent sequentially. We also reported net income of \$2.3 million for the quarter, or 5 cents per diluted share. While our year-over-year financial results comparison reflects the global economic downturn, we are cautiously optimistic about our near-term performance due to our sequential improvement in revenues and an improving bookings picture.

An important highlight this quarter was a significant recovery in pulsed laser sales over the prior period, driven primarily by strength in China for marking and engraving

applications. This more than offset a small sequential decline in high-power laser sales mainly due to price correction.

We are making great progress in developing relationships with OEMs in China for pulsed, low and high power applications, which bodes very well for the future in that geography. We also saw some recovery in pulsed laser sales in Europe, with the exception of Germany, and some growth in Japan. Business conditions are still weak domestically, although bookings increased during the quarter in the U.S. and our level of quote activity is strong.

Looking at our performance by applications . . . Advanced applications, which grew year-on-year and quarter-on-quarter, was a solid performer in Q3. The medical market has also firmed up and grew moderately quarter-on-quarter but more significantly year-on-year. We expect continued success in our efforts to diversify our customer base in this market. The materials processing market remains a challenge because of the economy, but appears to be showing some signs of improvement. Telecom was soft this quarter, although we are encouraged by our prospects there as well, starting in 2010.

I want to highlight some significant positive developments:

- The Presidential Committee for Modernization and Technological Development of the Russian Economy recently approved projects aimed at supporting domestic telecom equipment manufacturers in Russia. IRE-Polus, our Russian subsidiary, is recognized as a Russian domestic producer. The driver of the high speed optical network in the projects are

state of the art DWDM systems developed and made by us in Russia. .

We are now in a pilot project. The revenue opportunity to IPG is significant—multiple millions of dollars-- if the pilot project is successful, the projects are approved and IPG is ultimately selected.

- At an upcoming industrial trade show in China, seven systems integrators will present machines incorporating IPG's high-power fiber lasers. These are seven new integrators we developed in only a few months since we started selling high and mid power lasers at the end of last year. We have also made great progress in developing new OEMS and new applications with our products that contributed to the growth of sales in Korea.
- Our research efforts are resulting in new products that we are starting to ship. I want to talk about a few of them:
 - Our long-pulsed fiber lasers with kilowatt level of peak powers are new products that are competitive in performance and price to traditional flash lamp pump long pulse YAG lasers. With this product introduction, we have expanded our available market into a large segment where we did not compete before because of certain limitations of fiber lasers. These lasers are used in various spot welding applications, including battery welding and the electronics industry.
 - Second, I am pleased to announce that we shipped several of our pulsed green lasers and we see that demand is fast growing. We

have had some delays in development of our single frequency CW green laser which is undergoing internal qualification. We are hopeful that we can offer the green CW laser in Q1 2010.

- Third, last quarter, we completed internal qualification and started mass production and sale of our own beam switches used in our super power fiber lasers. Also, we are selling now a greater number of IPG-made high power delivery cables and couplers. This is meaningful because we have better margins on these than the ones we purchased before from sole suppliers. The yearly savings will be in the multiple millions of dollars.

I will now turn the call over to our CFO, Tim Mammen, to review the quarter in more detail.

Tim Mammen:

Thank you Valentin. Good morning everyone.

As Valentin mentioned, we exceeded guidance in the third quarter in both revenue and earnings.

We reported a profit of five cents in the quarter after recording a loss of three cents in the second quarter of 2009. We continued to control costs and capital expenditures, enhanced our already-strong balance sheet and generated \$12 million in cash.

With that, let's move right into our discussion of the four markets we serve . . .

Materials processing, which is IPG's largest market, contributed 76 percent, or \$35 million, of the total revenue we reported in Q3, down 31 percent year-over-year, but up 17 percent sequentially. Our materials processing business has been hit the hardest by unfavorable market conditions primarily as a result of lower demand for welding, marking and engraving applications.

The advanced applications market, which includes test & measurement, instrumentation, sensing and defense applications, as well as scientific research & development, performed well in the quarter. Advanced applications represented 15 percent of total revenue, or \$7 million, during the third quarter, increasing more than 33 percent year-over-year and 22 percent sequentially. The impressive growth for advanced applications primarily resulted from several high-power laser systems and special pulsed lasers used in sensing applications.

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The communications market comprised 4 percent, or \$2 million, of our total revenues in the third quarter decreased by about 54 percent year-over-year. Telecom sales were particularly weak in the U.S. The momentum that had been building in Russia during the past few quarters for telecom products for broadband access and cable TV slowed in the third quarter due primarily to customer timing and budget issues. We remain encouraged about our prospects for telecom in Russia and are currently being considered for some large projects building optical networking system solutions.

Sales for the medical application market comprised 4 percent of total revenue, or \$1.9 million, an increase of approximately 24 percent year over year and were relatively flat on a sequential basis. Medical application sales are beginning to stabilize, primarily due to growing demand in the U.S. for low powered lasers. In addition, a growing number of OEMs worldwide are purchasing lasers for medical applications on a more consistent basis. We continue to focus on diversifying our medical business customers by prospecting for new OEMs.

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

Pulsed lasers were our top selling product line in Q3, taking the lead over high power fiber lasers, with sales of \$16.2 million, and representing 35% of revenue. While these sales were down approximately 23 percent year over year, we were encouraged that sales were up by more than 63 percent sequentially. The sequential growth in pulsed lasers was driven primarily by strength in China, and parts of Europe, mostly for marking and engraving applications. Much of the year-over-year decline can be attributed to the solar applications business, which was very strong in the comparable quarter in 2008.

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Sales of our high power fiber lasers decreased by 24 percent year-over-year in Q3 to \$13.7 million and represented 30 percent of total revenue primarily due to weaker sales for welding applications partially offset by stronger sales for cutting applications. Sales for high power lasers were down about 12 percent sequentially from Q2 09 as a result of slower sales in the US.

Geographically, we are beginning to sell more high power lasers in China, India and Russia. We are also hopeful our new rep in Brazil will gain some traction. Late last year, we initiated a new strategy in China to sell our high power lasers into OEM systems manufacturers. The benefit of this strategy is that our new partners have many salespeople marketing the systems instead of our reps marketing our lasers to one customer at a time. This strategy is beginning to gain some noticeable traction, and we have already begun selling to some large Chinese OEM systems manufacturers, as Valentin mentioned. We also recently recorded several large high-power laser sales in Russia for industrial applications, such as welding and cutting. High power laser sales became a larger portion of revenues in Russia, which have been predominantly telecom-related over the past several quarters.

Sales of medium power lasers decreased 65 percent in Q3 of 2009 from Q3 of 2008 to \$2.8 million. Sequentially, medium power lasers fell about 34 percent. Much of the weakness in Q3 came from soft orders in microelectronics, printing and sintering. However, we did record several new medium power orders for welding and cutting applications in Russia.

Our low power lasers, which are primarily used for medical applications and micro materials processing, were down 19 percent year over year to \$4.0 million, but up 41

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percent on a sequential basis, and accounted for about 9 percent of total revenue.

Much of the sequential growth in low power lasers was from sales for medical applications.

From a geographic perspective, we reported 42 percent of total revenues from Asia and Australia, 39 percent from Europe, and 19 percent from North America.

We are seeing significantly improved performance in Asia, driven by returning strength in China, Japan and Korea. China is becoming a much stronger market for us than it has been in the past, primarily due to the new sales strategy that I just mentioned and the strong Chinese economy in Q3. We are developing many new relationships in that market that will be beneficial to us in the future.

With the exception of Germany, the rest of Europe performed well. Southern Europe was particularly strong, primarily as a result of growing demand from our cutting OEMs. As you may recall, earlier this year we qualified with a few cutting machine OEMs, who are marketing their new systems with our lasers.

We reported weak performance in the U.S., partly due to some revenue timing issues. While bookings shippable within one year in the U.S. were strong in the quarter, a number of these orders will not be fulfilled until Q1 or even Q2 of next year. In addition, the solar market in the U.S. remains soft. It is also important to note that we had a strong quarter for the U.S. in Q3 of 2008.

Turning now to the income statement . . .

Sales for the quarter were down 26 percent year-over-year to \$45.8 million, but up by more than \$5 million, or 13 percent on a sequential basis. We estimate that if exchange rates had been approximately the same as one year ago, our Q3 sales would have been \$0.2 million higher.

Gross margins were 36.5 percent in the third quarter of 2009, compared with 47.4 percent in Q3 '08. Gross margin was negatively affected by lower absorption of manufacturing costs as a result of lower sales, product mix due to fewer sales of medium power lasers and the impact of pricing pressure on average selling prices. Despite the reduction in our cost structure on an absolute dollar basis, manufacturing costs were higher as a percentage of sales. We estimate that if exchange rates had been approximately the same as one year ago, our Q3 gross profit of \$16.7 million would have been \$0.6 million higher.

While our gross margin is lower than we would like, with an improvement of 7.4 percentage points from the second quarter of 2009, we have demonstrated the ability to generate some positive momentum in gross margins when revenues begin to pick up again. As we increase our absorption rate as a result of higher sales, margin growth should continue to accelerate.

SG&A expenses were \$8.5 million, or 18.7 percent of sales in Q3 2009, compared with \$9.8 million, or 15.8 percent of sales, in Q3 2008 as we have continued to control discretionary spending related to consultants and accounting and legal. In addition expenses related to bad debt were lower in Q3 2009. We estimate that if exchange

rates had been approximately the same one year ago, our Q3 09 SG&A expenses would have been \$0.1 million higher.

I want to update you on recent activity involving our pending patent litigations since they have a direct bearing on our legal expenses. We previously reported that the 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 the new claims added during the re-examination. The stay on the litigation was lifted recently and this litigation has recommenced. The trial has been set to begin in August 2010. As a result, we expect to incur higher legal expenses in the coming quarters.

The lawsuit with CardioFocus remains in re-examination at the Patent and Trademark Office. The Patent and Trademark Office has cancelled most of the claims for the two of the three patents in question as the patent owner has abandoned those claims. The third patent remains under re-examination. Although the litigation stay has expired, IPG asked the court to extend the stay for a year. This request is pending.

R&D expenses were \$4.6 million, or 10 percent of revenues in Q3 2009. This compares with \$4.1 million, or 6.7 percent of revenues, in the third quarter of 2008. In the coming quarters, we anticipate R&D expenses to stabilize at these levels or slightly decline as production picks up and consumes labor resources now being focused on R&D.

Our Q3 09 exchange rate gain on transactions and the revaluation of financial assets and liabilities were a \$40 thousand gain in Q3 '09 compared to a gain of \$1.6 million in Q3 '08.

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IPG's operating income in the third quarter of 2009 was \$3.6 million compared with operating income of \$17.1 million in Q3 of last year, yet significantly improved from the operating loss of \$1.3 million in Q2 of '09.

Operating income includes stock based compensation related charges of \$783,000 and \$461,000 in the third quarters of 2009 and 2008, respectively. In the third quarter of 2009, \$164,000, \$506,000 and \$113,000 of stock-based compensation charges related to cost of sales, SG&A and R&D, respectively.

Our tax rate for the third quarter of 2009 was 31.5 percent. We estimate an overall tax rate of 31.5 percent for the year. The effective rate for 2008 was 32 percent.

Our third quarter net income attributable to IPG was \$2.3 million, or 5 cents per diluted share, compared with net income of \$10.9 million, or \$0.23 per diluted share, for the third quarter a year ago.

Year-to-date cash generated from operations has exceeded the amount spent on investing activities by more than \$28 million.

Capital expenditures were \$1.9 million for the third quarter, and \$9.6 million year-to-date. As you know from past conference calls, we had been targeting CapEx of less than \$15 million for the year.

In the third quarter, using the cash generated this year, we repaid \$17 million of our outstanding credit lines. Our cash and cash equivalents net of debt at the end of the third quarter of 2009 were \$42.5 million, compared with \$12.2 million at December 31, 2008. Cash and cash equivalents improved from year end by \$25.0 million to \$76.3 million at the end of the quarter. Not included in cash and cash equivalents are \$1.3

million in auction rate securities at September 30, 2009, which are included in other long-term assets.

Cash flow from operations in the third quarter was \$13.9 million. Cash used in investing activities was \$1.7 million and cash used by financing activities was \$14.9 million.

Accounts receivable decreased to \$29.8 million at September 30, 2009 from \$41.8 million at December 31, 2008. Days sales outstanding were 59 days at the end of Q3 compared to 65 days at the end of 2008. The lower DSO at September 30 reflects the timing of sales made during the quarter with more sales shipped earlier in the quarter as compared to the quarter ended December 31, 2008.

Finally on the balance sheet, inventory decreased to \$59.2 million at September 30, 2009 from \$72.6 million at the year-end 2008 in part due to the reserves we have booked this year but also due to consumption of inventory and managing production and purchasing.

As mentioned in our news release this morning, we expect to file with the SEC, shortly, a universal shelf registration statement that will allow the company to register up to \$130 million in securities, including \$30 million in secondary shares. The proceeds of any future offering could be used for a variety of purposes. At this time, we have no immediate plans to issue securities under the shelf, but it will provide us with the financial flexibility to do so at the appropriate time. This filing is nothing more than proactive capital structure planning.

This leads us to our expectations going forward...

In the second quarter of this year we reported more than \$40 million in revenue and had a book to bill of more than one. That drove a 13% sequential increase in revenue to \$45.8 million in Q3. In the third quarter on revenues of just over \$45 million, we have a book to bill also greater than one. A number of the recent bookings are for Q1 and Q2 of next year, however. While we performed very well from a revenue standpoint in Asia in Q3, corporate buyers are still cautious in the U.S. and in Europe -- especially Germany. So we believe that we may have seen the worst of the macroeconomic environment. However, we'll offer the caveat that like everyone, we don't know where the market will end up in the short term and beyond.

So let me now provide you with our guidance....

For the fourth quarter, IPG Photonics expects revenues in the range of \$44 million to \$49 million. The Company anticipates earnings per diluted share in the range of \$0.04 to \$0.09. That is based on 46,695,000 diluted common shares, which include 45,573,000 basic common shares outstanding and 1,122,000 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 we go to Q&A, let me summarize five key points:

First, we performed better than our guidance in the third quarter, generating a five cent profit and growing revenue sequentially by 13 percent.

Second, we were able to increase gross margins sequentially in the quarter showing the leverage in our business model. Also, we continued to control costs and reduce capital expenditures.

Third, we saw a recovery in pulsed lasers, driven primarily by strength in China, where we continue to build our presence in several product lines. The overall strength in China is offsetting weakness in the United States, although the bookings picture in the United States is improving.

Fourth, we have a strong balance sheet and have demonstrated excellent cash generating ability.

And finally, customers continue to see the value in IPG's lasers and technology, which can lower their costs and improve the way they manufacture their products. Despite the weakened demand due to the economy, IPG is winning many competitive bids with competing laser technologies because our customers recognize the benefits of our technologies and fiber lasers are now becoming widely accepted.

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