

Power Integrations, Inc.
Fourth Quarter 2014 Financial Results Conference Call
February 4, 2015

Operator: Good afternoon. I'd like to welcome everyone to the Power Integrations Fourth Quarter 2014 Results call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question and answer session. To ask a question during that time, simply press star, then one on your telephone keypad. Thank you. Joe Shiffler, you may now begin your conference.

Joe Shiffler: Good afternoon and thanks for joining us to discuss Power Integrations' financial results for the fourth quarter of 2014. With me on the call are Balu Balakrishnan, President and CEO of Power Integrations; and Sandeep Nayyar, our Chief Financial Officer.

During today's call, we will refer to financial measures not calculated according to Generally Accepted Accounting Principles. Please refer to today's press release available on our website at investors.power.com for an explanation of our reasons for using such non-GAAP measures, as well as tables reconciling these measures to our GAAP results.

Our discussion today, including the Q&A session, will include forward-looking statements reflecting our forecast of certain aspects of the Company's future business and financial results. Such statements are denoted by words like "will," "would," "believe," "should," "expect," "outlook," "estimate," "plan," "goal," "anticipate," "project," "potential," "forecast," and similar expressions that look toward future events or performance. Forward-looking statements are based on current information that is dynamic and subject to abrupt changes. Our forward-looking statements are subject to risks and uncertainties, which may cause actual results to differ materially from those projected or implied in our statements. Such risks and uncertainties are discussed in today's press release and in Part II of our most recent Form 10-Q, filed with the SEC on November 3, 2014.

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Now, I'll turn the call over to Balu.

Balu Balakrishnan: Thanks Joe, and good afternoon. Fourth quarter revenues came in about the midpoint of our projected range at \$86.6 million, while non-GAAP earnings were \$0.59 per share, benefiting from expense control plus the reinstatement of the R&D tax credit.

For the full year, revenues were \$349 million, just a slight increase from 2013. This performance is clearly not to our expectations, and I'll focus my remarks today on the reasons we expect to deliver better results in the coming year.

First, we expect a turnaround in the communications end market in 2015. While sales into the consumer, industrial, and computer markets grew in 2014, communications revenues declined by nearly 15%. This was due in part to soft demand at our two largest end customers, but also reflected increased commoditization in mobile phone chargers which make up a substantial portion of our communications revenues.

Starting in 2015, rapid charging presents an opportunity for differentiation that hasn't existed in the charger market in recent years. The increased power requirements of rapid charging create technical hurdles for designers in terms of form factor, efficiency, and component count, which in turn creates a need for innovative, highly integrated products like ours. We are now in high-volume production for rapid charge designs at several top-tier mobile phone OEMs, including both the world's largest and fastest-growing smartphone vendors, and we expect revenues from this market to ramp throughout the year.

A second growth driver for 2015 is the start of the promising new product cycle led by the revolutionary new InnoSwitch family. InnoSwitch is the first IC product to integrate both primary and secondary sides of the power supply, resulting in drastically reduced complexity, size, and energy losses. Rapid charging is an ideal application for InnoSwitch, but the product is also well-suited for a wide range of other applications, and we're seeing a strong customer response since launching the product for general availability in November.

Demand for InnoSwitch actually exceeds supply for the current quarter, and we expect a healthy increase in sales beginning in Q2 as our production catches up with demand.

A third key driver for 2015 will be energy efficiency, which remains a secular trend across all of the major markets we address, from electronics and appliances to lighting and industrial. While not a new trend, energy efficiency takes on added importance in the electronics market with the pending onset of DoE 6, the next iteration of mandatory federal standards for external power supplies. Set to take effect in 2016, DoE-6 calls for increased active-mode efficiency and a substantial reduction in no-load consumption for external chargers and adapters.

DoE-6 may be the most impactful update to power supply efficiency standards in the US since the original California Energy

Commission standards took effect in 2007. We are already seeing strong redesign activity with InnoSwitch and with our newly announced LinkSwitch-4 products, both of which comfortably meet the new standards. While the full impact of the standards won't be felt until next year, we anticipate uplift in sales over the course of 2015 as compliant designs start going into production.

While DoE-6 applies to external power supplies, energy efficiency continues to be an important factor for embedded power supplies as well. In the consumer market, our dollar content is expanding thanks to the increasing use of electronic features in white goods and countertop appliances. The additional features add to the challenge of meeting standby efficiency requirements, such as the European EcoDesign Directive, which in turn increases our content even further. With the appliances continuing to become smarter and more connected, we expect this trend to continue for years to come.

In the industrial market, we see energy efficiency as a long-term driver across the full range of power levels. On the lower end of the scale, we enable clean technologies like LED lighting and smart utility meters, while our high-power IGBT drivers are critical components in renewable energy systems, the transmission of high-voltage DC on the power grid, and the efficient consumption of energy in heavy industry and transportation.

Although softness in oil exploration markets and other macro factors are affecting demand for IGBT drivers in the current quarter, we have a robust outlook for the high-power business beyond the first quarter and expect overall industrial revenues to grow nicely in 2015.

Energy-efficiency also played a key role in our acquisition of Cambridge Semiconductor, or CamSemi, which closed in early January. This transaction, our first since the 2012 purchase of CT-Concept, is consistent with our history of highly selective M&A in our core competency of high-voltage power conversion.

CamSemi brings a talented team of engineers with deep expertise in AC-DC power supplies, and we plan to operate their UK headquarters as an R&D center focused on accelerating our product development for the low-power market. The acquisition also broadens our technology and product portfolio for low-power applications, especially for high-efficiency chargers and adapters designed to meet tight requirements like the upcoming DoE-6 standards.

In summary, while disappointed with our 2014 performance, we look forward to the renewed growth in 2015. The technology behind InnoSwitch is among the most significant breakthroughs in the history of the power supply industry, and arrives at an opportune moment with the

convergence of rapid charging and the new energy-efficiency standards. With energy-efficiency providing a broad-based tailwind, we think the pieces are in place to drive growth across all four of our end-market categories, and we expect momentum to build through the year as these drivers take shape.

And with that, I will turn it over to Sandeep for a review of the financials.

Sandeep Nayar: Thank you, and good afternoon. Since our fourth quarter results are fairly straightforward, I'll just quickly cover the Q4 financials before commenting on the Q1 outlook and the impact of the CamSemi acquisition. I'll focus my remarks primarily on the non-GAAP numbers, which are reconciled to the corresponding GAAP numbers in the tables accompanying our press release.

Fourth quarter revenues decreased 4% sequentially to \$86.6 million, just above the midpoint of our projected range. The sequential decrease was driven by the computing and industrial end markets. Sales into the consumer end-market were flat, while communications revenue increased sequentially.

Revenue mix for the quarter was 37% consumer, 33% industrial, 21% communications, and 9% computer. The proportion of revenues coming from the lower-margin communications end market increased by 3 percentage points, while industrial's share fell by 2 percentage points. That change in mix, combined with increased shipments of newer products, like InnoSwitch, resulted in sequentially lower non-GAAP gross margin of 53.9%, in line with our forecast.

Non-GAAP operating expenses for the quarter came in below our forecast at \$29.1 million, unchanged from the prior quarter. Non-GAAP operating margin for the quarter was just over 20%.

Our non-GAAP tax rate for the quarter was approximately zero, reflecting recognition of the full year's R&D tax credit within Q4, bringing our full-year tax rate to 4.7%. Including the tax benefit, non-GAAP earnings were \$0.59 per diluted share.

Our weighted-average diluted share count for the quarter was just over 30 million shares, down more than 2% from the prior quarter reflecting share-repurchase activity. We took particular advantage of the volatility in the semiconductor stocks during the month of October, consistent with our opportunistic approach to capital allocation. For the full quarter, we bought back 728,000 shares at an average price of less than \$49 per share. \$23.7 million remain on our buyback authorization at quarter-end. We also paid

out \$3.5 million in dividends during the quarter and used \$5.7 million of capital expenditures.

Driven mainly by the buyback, cash, and investments on the balance sheet decreased by \$38.6 million during the quarter, ending the quarter at \$175.3 million.

Internal inventories increased by about \$7 million during the quarter, rising to 143 days on hand at quarter-end, while channel inventories declined by nearly a full week to 6.5 weeks. We expect internal inventories to remain somewhat elevated for the current quarter, but settle back down toward our targeted range as the year progresses. We have virtually no obsolescence risk in our product portfolio and are content to adjust inventory levels gradually, as we have done throughout our history.

For the first quarter of 2015, our revenue outlook reflects the seasonal patterns we've seen the past couple of years in Q1, as well as the macro-driven softness we are currently seeing in the high-power business. These factors are partly offset by revenue from CamSemi plus the continuing ramp of InnoSwitch, albeit limited by short-term supply constraints. All in, we expect first-quarter revenues to be between \$82 million and \$88 million.

We expect non-GAAP gross margin to be between 53% and 53.5%, down modestly from Q4 reflecting end-market mix plus the continuing ramp of newer products. While new product ramps will be a margin headwind throughout the year, we also expect a meaningful benefit from the weaker yen beginning in the third quarter, such that our gross margin should bottom in the second quarter and then move slightly higher in the second half of the year.

Non-GAAP operating expenses for the first quarter should be approximately \$31 million, as compared to \$29.1 million in Q4. The increase reflects the addition of CamSemi, as well as normal seasonal factors such as resumption of FICA taxes and the December shutdown. While CamSemi has not yet achieved profitability as a standalone company, we expect to realize meaningful synergies over the first half of the year, making the acquisition earnings-neutral by the third quarter.

Lastly, I expect the non-GAAP tax rate for the first quarter and for the year to be approximately 7%, assuming for now that the R&D tax credit is not reinstated.

With that, I'll turn it back over to Joe.

Joe Shiffler: Thanks, Sandeep. We'll open it up now for questions and answers. In the interest of time, we'd ask that callers limit themselves to two

questions at a time, but we will be happy to come back around for a second round of questions as time permits. Operator, would you please now give the instructions for the Q&A session?

Operator: At this time, I'd like to let everyone know that to ask a question, please press star, and the number one on your telephone keypad.

Our first question does come from Steve Smigie at Raymond James. Your line is now open.

Steve Smigie: Great. Thanks a lot, guys. I was hoping you could talk a little bit more about CamSemi in terms of what's the revenue impact in March and the operating expense impact?

Sandeep Nayyar: So, the revenue impact, as we said, is kind of—is about—somewhere between \$1.5 million to \$2 million, and that kind of helps us offset the macro thing that we're having related to the high power. As far as the expenses, the increase that we talked from the \$29.1 million to \$31 million, about two-thirds of that is related to CamSemi.

Steve Smigie: Okay, great. Then, just in terms of the InnoSwitch, can you talk about what sort of the first couple main end-market applications you're getting into, and when you get your capacity ramped, how big could that be this year?

Balu Balakrishnan: Well, the first designs we've got are in the rapid charging area, which is in cell phones. At the moment, we are shipping to three tier-one OEMs in the cell phone space, and we will start shipping to two other OEMs in Q1, this quarter. In addition to that, we have won about half a dozen tier-two type design wins, and they will all start ramping in Q3, and we expect to get more design wins as time goes on.

Now, you notice that we also introduced that product as a standard product to the broader market in November of last year, and that has generated a huge amount of interest from various areas, including consumer electronics and appliances, industrial, and so on. We got our first design win just recently in a consumer electronics product and we expect to get more design wins through the year.

So, just to remind you, initially, we focused on rapid charging because it seemed like the best place to get the most return on investment, but later in the year last year, we broadly introduced the product and we are seeing the benefit of that starting, I would say, Q2 of this year.

Steve Smigie: Okay, great. If I could just sneak one more in. Can you give some color on LED lighting opportunity this year? Sometimes you give

a sense of what type of growth you might be able to get, so I was just wondering if you might be able to give that kind of color for growth in that business this year.

Balu Balakrishnan: Sure; 2014 was a disappointing year for us in LED, primarily because the low-end of that market—that is, if you take the bulb market, which is the low-end—within the bulb market, the emerging market segment, which is very low-end, which has no special requirements like power factor corrections or dimming, that market has become very commoditized and most of the designs there are done in China and using Chinese solutions. So, that end of the market, we lost share—because we had actually quite a bit of that share because of our history with our products. So, we lost some share there to the Chinese companies. However, we are doing very well in the high-end of the bulb market, which is the market that is served by the well-known lighting companies, and those require the benefits we bring of integration.

Also, the commercial lighting and industrial lighting, including street lighting, traffic lights, signage, and commercial replacements for tube lights and so on, those are doing very well, but because we lost share, we didn't actually grow last year. The growth in the higher end of the segment was offset by the loss of share in the low end of the segment. So, we are actually slightly below 2013 in revenue in 2014.

However, now that we have reached kind of an equilibrium, we expect LED lighting to grow this year, and we actually like the markets we are in because those are higher margin markets and also those appreciate the benefits we bring. So, we think in 2015, the LED market will grow for us.

Steve Smigie: Okay, great. Thank you.

Operator: Your next question comes from Ross Seymore at Deutsche Bank. Your line is now open.

Ross Seymore: Hi, guys. Just—Sandeep, a question for you on the gross margin trajectory. Can you walk us through some of the assumed levers that create the bottom in the second quarter; and when you say the second quarter is going to be the bottom, does that imply that you expect the gross margin to drop from 1Q to 2Q?

Sandeep Nayyar: Yes, we do expect the margin—first of all, there's a lot of puts and takes. As I said in my remarks, the new product ramp's going to be a headwind and the mix is going to be a headwind, because we have more cell phone business with rapid charging, and the CamSemi acquisition is also focused more towards those end applications, so as a result, we are expecting the margin from Q1 to Q2 to bottom, and what's going to happen is that we expect that the yen benefit, because of the inventory levels, will start

meaningfully flowing in Q3, which will enable us to get the margins going up in the third quarter and then flattening out. Now (cross talking). Sorry, go ahead, Ross.

Ross Seymore: I was just going to say, you know, the yen stuff is great, and that's always a put and take, but from what you can control, on more of an organic basis, when do you expect the gross margin to start improving again off of that 2Q base?

Sandeep Nayyar: We have cost reductions which will start kicking in, and in the next year we bring up the follow-on product to this generation of InnoSwitch. It's very hard to predict because of the mix, but this year we are expecting the full-year margin to be, for modeling purposes, somewhere in the 52.5% to 53% range. We always have cost reductions, and the new product ramps this year are being a headwind, but with the next generation, especially with the case of Inno, because it being such a revolutionary product, and if the next generation comes out next year, we will see further benefits. But, if you look at it, because of the mix, what had been and not being challenged in the cell phone business, our margin had been on the high-end or slightly above our range. Now, we are kind of seeing this somewhere in the middle of our range.

Ross Seymore: Okay, and then I guess my last question, or my follow-up question would be—it sounds like there's a lot of mixed dynamics going on with the new products penetrating. I guess I would have thought that if the new products are going to penetrate that they would—for them to be that impactful on the mix, by definition, they'd have to have a bigger revenue ramp. Then, if I put that together, how do I think about the revenue contribution from these new products and how should it be accretive to what your traditional organic growth rate would be, or is there some substitution effect going on where something else is falling off greater than I'm appreciating?

Balu Balakrishnan: Well, I would say that the new products, from everything we can tell, should give us a significant growth in Q2, and should continue to grow throughout the year. The Q1, the main challenge we've had is that—first of all, seasonally, if you look at the last two years, we've been down in Q1, but the only other thing that's happening is that our high power revenue in Q1 is down for a couple of reasons. One is the oil exploration demand for IGBT drivers has gone down, for obvious reasons, because oil prices have gone down, so that has brought down the revenue in the high power. But, in addition to that, we have some revenue coming from Russia that essentially went away in Q1, it's going away in Q1, and that's because the ruble has gotten devalued so much that the customers in Russia are unable to pay for the devices, so they're not purchasing the devices.

So, the combination of those two will reduce our revenue in high-power by about \$1.5 million to \$2 million, which essentially gets

offset by the contribution of CamSemi revenue in Q1. So, if you set that aside, our Q1 revenue is consistent in seasonality, but starting in Q2, we have a number of drivers, including the InnoSwitch in rapid charging, the LED revenue will continue to grow, and also our PC revenue should start growing, because it's gone down significantly in Q4, by 20% or so, and that doesn't reflect demand. It's some kind of an inventory adjustment that seems to happen every year. Last year and the previous year, it happened in Q1, but this year, for some reason, it happened in Q4. We think it could be because of the fact that the Chinese New Year is much later this year than last two years. So, those are kind of the dynamics that are happening at this time.

Ross Seymore: Great. Thank you.

Balu Balakrishnan: You're welcome.

Operator: Your next question comes from the line of Tore Svanberg from Stifel. Your line is now open.

Evan Wang: Yes, hi. This is Evan Wang calling in for Tore Svanberg. My first question is about your communications business and about your rapid charger opportunity. Your communications revenues have been as high as 92 million plus in 2010. So, when you look at the opportunity that you have in front of you in rapid charge, do you think it's possible you could return to that level?

Balu Balakrishnan: That's a good question. We haven't thought that far, but we expect the revenue to grow very nicely this year and also next year. There is the possibility we could get to that level if rapid charging becomes adapted widely, but we should grow very strongly this year in that area, because we have won a number of designs. We have four of the top names in China using our product, not in all of their phones, but we have designs in each one of those four companies—OEMs I should say. We are in two big ones in Korea and a number of other tier-two companies using our InnoSwitch product.

Evan Wang: Very nice, thank you. Let me switch gears and ask a question about your distribution channels, the inventory. Now that it's down a week at 6.5 weeks, how comfortable are you with that and what is the implication going forward? Do you think distributors will start ordering at a more accelerated pace going forward, or will they maintain this level? Could you just give a little more color on that?

Sandeep Nayyar: Typically, what happens in Q1 is—and that's why we see the level—the adjusted inventory levels in December, they tend to kind of build a little more in Q1, that's been our historical, and we are seeing that in the strong bookings in January, but, again, you have to keep in mind, that, along with the Chinese New Year being delayed, what is attributing to that is a little difficult

and early to tell, but, typically, we have seen them increase the level slightly in Q1, in at least the last two or three years.

Evan Wang: Okay, great. Thank you very much.

Operator: At this time, I'd like to remind everyone to ask a question, please press star, and the number one on your telephone keypad.

Your next question comes from the line of Christopher Longiaru, your line is now open, from Sidoti & Company.

Christopher Longiaru: Hey, guys, thanks for taking my question.

Balu Balakrishnan: You're welcome.

Christopher Longiaru: My first—just on the goal here with Cambridge moving, you know, I guess, into a little more low-power, AC to DC power supplies, first, where can you expand and what's the strategy for that acquisition going forward? Also, just in terms it's not a huge number, but there seems like a little bit of an elevated op ex number tied to that, what are your plans past March and June in terms of where you end up on the op ex front with the integration of that?

Balu Balakrishnan: Well, first of all, the primary reason for acquiring Cambridge Semiconductor is the talent, the engineers there, they have very good design engineers, application engineers, test engineers, and so on, and this is a very quick way for us to expand our R&D development. We have a lot of good ideas and not enough people to implement them, and so this, we thought of an opportunity, because they're already very familiar with the AC to DC power supply business as a whole. That's number one.

But, in addition to that, it so happens that they do bring some very interesting technologies that's of great interest to us, and we're going to combine their technologies with our capabilities to offer some very attractive products, not necessarily limited to low power. They have been definitely focused on the low power area, but the technologies they have, in combination with our process technology and design technology, will allow us to offer very attractive products across our entire broad range of markets.

It also happens—so happens that they have revenue in the cell phone space that we will take over, and we will also expand that revenue by exposing those products to a broader range of customers. Right now, they literally have a handful of customers they address because as a small company, that's all they can do. So, given that we can grow the revenue, we think by Q3 we can make that acquisition break even from an EPS point of view, and beyond that, we should get some accretion. However, as time goes on, it

will be harder to differentiate, specifically, their revenue from our revenue, because we'll be combining the technologies to make good products overall.

Christopher Longiaru: You mentioned just a couple synergies on the op ex front. Is there anything—I mean, I know that they're a lot smaller than you are, but is there anything meaningful there in terms of where we go from the March quarterly guide on op ex?

Balu Balakrishnan: Well, there is—you know, we have—we are reducing the number of people from roughly about 50 to about 30 or so. Some of them are going through a transition right now, but they'll be off by Q2. That's already in the transition costs that we have shown in the GAAP results. So, beyond that, the accretion's going to come from growth in revenue, not necessarily in costs, because we want these people.

Christopher Longiaru: Then, you mentioned the revenue from Russia going away due to the decline in the currency. Is that revenue expected to return or is that—are they just holding off on purchases? Can you give us a little more in terms of how you expect that business to trend long term?

Balu Balakrishnan: It's not a lot of business, but because it's completely gone away, it is noticeable in Q1. It's roughly on the order of a little over \$1 million a year. It is hard to tell whether it will come back. However, we are not basing our projections for growth in high power on it coming back. We think we have many multiple drivers in high power that should drive growth from Q2 onwards.

Christopher Longiaru: That's all I have. Thank you guys.

Balu Balakrishnan: You're welcome.

Operator: There are no further questions. I'll return the call now to the presenters.

Joe Shiffler: Okay. I know there are a couple of calls people are probably listening to at the same time. We can give a few more seconds to see if anyone has any further questions.

Operator: Again, it is star, and the number one to ask a question.

Joe Shiffler: Okay, all right. Well, since it looks like there are no further questions, we'll end it there. Thanks everyone for listening. A replay of this call will be available on our website at investors.power.com. Thanks again for listening, and good afternoon.