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EDITED TRANSCRIPT

POWI - Q3 2019 Power Integrations Inc Earnings Call

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OVERVIEW:

Co. reported 3Q19 revenues of \$114.2m and non-GAAP earnings of \$23.3m or \$0.78 per diluted share. Expects 4Q19 revenues in range of \$114m, plus or minus \$3m.



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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Power Integrations' third quarter earnings conference call. (Operator Instructions) I would now like to hand the conference over to your speaker today, Joe Shiffler, Director of Investor Relations. Thank you. Please go ahead, sir.

Joe Shiffler - *Power Integrations, Inc. - Director of IR & Corporate Communications*

Thank you. Good afternoon, and thanks, everyone, for joining us. With me on the call today are Balu Balakrishnan, President and CEO of Power Integrations; and Sandeep Nayyar, our Chief Financial Officer.

During the call today, we will refer to financial measures not calculated according to generally accepted accounting principles. Please refer to today's press release, which is posted on our investor website, 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, which may be denoted by words like will, would, believe, should, expect, outlook, forecast and similar expressions that look towards future events or performance. Forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from those projected or implied in our statements. Such risks and uncertainties are discussed in our press release and in our most recent Form 10-K filed with the SEC on February 13, 2019.

Finally, this call is the property of Power Integrations and any recording or rebroadcast is expressly prohibited without the written consent of Power Integrations. Now I'll turn the call over to Balu.

Balu Balakrishnan - *Power Integrations, Inc. - President, CEO & Director*

Thanks, Joe, and good afternoon. Before we get to our third quarter results, I'd like to comment on the conclusion of our litigation with ON Semiconductor. We believe this settlement is a landmark win for our company, demonstrating the durability and the value of our intellectual property as well as our determination to protect it from unlawful use. As many of you know, this litigation began 15 years ago, when infringing products from Fairchild were doing serious harm to our business. Being a much smaller company at that time, we knew that patent litigation would have a meaningful impact on our bottom line and distract us from running the business. Nevertheless, as an innovation-driven company, we knew that the long-term health of our business depends on ensuring that our intellectual property is used solely for the benefit of our company and its owners.



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Indeed, IP protection has been deeply ingrained in our culture from the earliest days of the company, guiding everything from our choice of manufacturing partners to the location of our R&D centers to our IT policies and our rigorous approach to writing patents. We are confident from the outset -- we were confident from the outset that in spite of the cost, litigation was the right path and the outcome has proved us correct. We won permanent injunctions in 2008 and 2014, covering hundreds of infringing Fairchild products, sheltering our market share and our margins while enhancing our reputation as the leading innovator in our space. And while the removal of infringing products from the market was our primary aim, we also sought compensation for the harm done to our business. That goal was achieved in large measure this week when we received \$175 million from ON Semiconductor. All litigation between the 2 companies is now being withdrawn, and we expect a substantial reduction in operating expenses beginning in the first quarter of 2020.

While this litigation is now in the past, we expect it to have important consequences going forward. As valuable as our earlier inventions have proved to be, we believe our biggest breakthroughs and our most valuable IP have only recently come to market. Innovations such as our InnoSwitch products, our FluxLink isolation technology and our new GaN switches are fundamental technologies that will help fuel our growth for many years to come. And we have more such technologies in the pipeline. We hope that our success in combating infringement in the past will discourage such activity in the future.

Moving on to our third quarter results. Revenues increased 11% sequentially to just over \$114 million. That's an increase of 4% compared to the third quarter of last year, as we returned to year-over-year growth ahead of the broader analog industry. While revenues from the broad-based industrial and consumer categories remain below the levels of a year ago, Communications revenue grew nearly 40% year-over-year in the third quarter as we continue to win market share in the smartphone charger market.

As we have discussed in -- on prior calls, the mobile device market is rapidly adopting faster chargers as OEMs look for new features to differentiate their products. This trend is enhanced by the use of larger batteries, which, of course, take longer to charge unless they are paired with a higher-wattage power supply. The introduction of 5G phones should further reinforce the trend, as 5G functionality is expected to stimulate even greater usage of mobile devices. Our InnoSwitch products are the clear leader in fast-charging applications, offering the highest levels of efficiency and integration available in the market. Efficiency is a crucial factor in fast chargers since wasted energy produces heat. Dissipating heat typically requires 2 things, neither of which is desirable in mobile devices. Heatsinks, which add weight as well as cost and surface area, which, by definition, means a larger enclosure. This direct relationship between efficiency and size in fast chargers results in a substantial competitive advantage for our products.

In Q3, our InnoSwitch3 and InnoSwitch3-Pro devices won several new high-volume designs for fast chargers ranging from 15 to 30 watts. We also won our first inbox design for a GaN-based charger, a 65-watt design for a major Chinese OEM, which we believe to be the highest-power adapter ever packaged with a phone. According to the OEM, it delivers a 0% to 100% charge in half an hour with a small form factor and no heatsinks, which can only be achieved with the efficiency of the GaN-based InnoSwitch products.

As we noted last quarter, we believe we are the only company currently shipping high-voltage GaN products in high volume. In addition to this new inbox design, our GaN-based products are already being used in a variety of aftermarket chargers that are widely available at retail. In fact, I was pleased to deliver the 1 million units of GaN-based InnoSwitch products last month to the CEO of Anker Innovations, one of the world's leading suppliers of aftermarket power supplies and an early adopter of our GaN-based devices. Our sales of GaN-based ICs are now closing in on 3 million total units shipped, and we expect to be shipping more than 1 million units per month in the very near future.

Looking ahead to the fourth quarter, we are projecting revenues of \$114 million, plus or minus \$3 million, which would be an increase of 22% year-over-year at the midpoint. While smartphone chargers will again be the key growth driver, we also expect a return to year-over-year growth in the consumer end market. Sell-through in consumer has exceeded sell-in for 4 consecutive quarters, indicating that while there is apprehension in the supply chain, inventory levels are healthier than they were a year ago. And while trade-related headwinds continue, we remain as excited as ever about the fundamentals of the appliance market, which not only values the reliability and efficiency benefits of our products, but also continues to experience raising dollar content and growth from the expanding middle class in emerging markets.



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In addition, our new BridgeSwitch motor drive products give us an entirely new growth vector in appliances. And we are highly encouraged by the level of customer interest. We expect our first design win with BridgeSwitch to go into production in Q4, and we anticipate a gradual but steady ramp beginning in 2020.

With that, I'll turn it over to Sandeep for a review of the financials.

Sandeep Nayyar - *Power Integrations, Inc. - CFO & VP of Finance*

Thanks, Balu, and good afternoon. While we are still working to finalize the accounting and tax implications of the litigation settlement, I will begin by briefly summarizing our current expectations. First, as Balu mentioned, we received a payment of \$175 million from ON Semi earlier this week. We expect to pay out between 12% and 16% of this amount in cash taxes before the end of the fourth quarter. Including our normal quarterly free cash flow, we should exit the year with around \$400 million in cash and investments on our balance sheet. We intend to continue managing our cash as we always have, using a combination of internal investment, selective M&A, opportunistic buybacks and dividends to return value to our shareholders. As noted in our press release, our Board has increased the quarterly dividend to \$0.19 per share effective in the current quarter.

On the income statement, our results for the fourth quarter will include a gain along with an offsetting tax expense. Beginning in the first quarter of 2020, we also expect a reduction in operating expenses. Prior to the settlement, we were on a run rate of \$8 million to \$9 million in annual spending for patent litigation, the bulk of which was related to the now settled cases. Our current expectation is that the litigation expense will fall to approximately \$2 million in 2020, based on cases currently pending. We intend to reinvest 25% to 30% of the savings into the business, resulting in an expected annual expense reduction of about \$4 million for 2020.

Now I will briefly cover our Q3 financial results, which are very straightforward. Revenues were \$114.2 million, just above the midpoint of our range and up 11% from the prior quarter. The increase was driven by Communications category, which increased more than 30% sequentially, driven by strength in cellphone chargers. Industrial revenues were also strong, increasing double digits sequentially, driven by high-power applications, smart meters and other broad-based industrial applications.

Consumer revenues were down mid-single digits sequentially, reflecting seasonal softness in air conditioning, while Computer revenues were down slightly from the prior quarter. Revenue mix for the quarter was 34% Industrial, 32% Consumer, 29% Communication and 5% Computer. From a margin standpoint, the strength in Industrial largely offset the pressure from higher Communications revenue while cost reductions provided some uplift, resulting in a non-GAAP gross margin of 52%. That's up 80 basis points from the prior quarter and at the high end of our guidance. Non-GAAP operating expenses were \$35.4 million, down about \$800,000 sequentially and below our forecasted range, driven by the timing of headcount addition and equipment purchases. Non-GAAP operating margin increased by 500 basis points sequentially, reaching 21%. The non-GAAP effective tax rate for the quarter was 7%, bringing our non-GAAP earnings to \$23.3 million or \$0.78 per diluted share. Cash flow from operations was \$21.8 million for the quarter, while CapEx was \$6 million.

Inventories were flat in dollar terms, but fell by 15 days from the prior quarter to 144 days. Inventories are down by 34 days over the past 2 quarters, though I do expect a modest rebound in the December quarter. After a drop of 2 full weeks in the June quarter, channel inventory ticked back up as is typical of the September quarter. Specifically, weeks in the channel rose to 7.6 weeks, up 9/10 of a week from the prior quarter.

Looking ahead, we expect fourth quarter revenues to be in the range of \$114 million, plus or minus \$3 million. I expect Consumer revenues to be slightly higher as a percentage of revenue as air conditioning rebounds from the seasonal slowdown in Q3. As a result, mix should provide a slight help to gross margin along with continuing cost reduction. Specifically, I expect non-GAAP gross margin to be around 52.5%, which would be an increase of about 50 basis points from the September quarter. Non-GAAP operating expenses for the fourth quarter should increase sequentially, driven largely by headcount growth. I expect non-GAAP OpEx to be between \$36 million and \$36.5 million.

Lastly, I expect the non-GAAP tax rate for the quarter to remain at around 7%. And with that, I'll turn it back over to Joe.



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Joe Shiffler - *Power Integrations, Inc. - Director of IR & Corporate Communications*

Thanks, Sandeep. We'll open it up now for the Q&A session. [Stephanie], would you please give the instructions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Tore Svanberg with Stifel.

Tore Egil Svanberg - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Congratulations on the results and especially on the settlement with ON. First question, Balu. So now that we are looking at the fast-charger market kind of moving into a higher gear, I guess that means higher power levels, could you talk a little bit about where is the market right now in, let's say, 18-watt adapters and above? And then perhaps, on the other hand, how much of the market today would you say is GaN-based adapters, just so we can get a sense for how low the penetration is right now and where it's eventually headed?

Balu Balakrishnan - *Power Integrations, Inc. - President, CEO & Director*

Thanks, Tore. In terms of fast charging, most of the OEMs have gone to somewhere in the 15- to 25-watt range for their smartphones. There are still some 5-watt designs in place, maybe 10-watt designs. But we are seeing that rapidly switching over to the higher-power chargers, it's so dynamic, I couldn't tell you exactly what percentage at this moment it is. So it's -- that's good news for us because we see that happening very fast. Now as far as GaN-based chargers, that really go into the high end of the spectrum. It is just beginning as we speak. We mentioned the 65-watt charger announcement, which happened on October 10. And that is by far the largest-wattage charger we've ever seen with the cellphone. But we are hoping -- we are hopeful that other people will follow because it is a significant advantage to the user to be able to charge the phone faster. So if there is a kind of a war between OEMs to see how fast it can charge, that could take off quite well, but it's hard to predict at this point.

We are working with a number of OEMs and aftermarket customers. And you have already seen that there are many aftermarket products using GaN-based chargers because they are the early adopters. But we are optimistic that GaN will spread over time. This year, we're expecting something in the mid-single-digit million dollars in revenue, and that could very well be in -- well into double digits next year in terms of millions of dollars in revenue for GaN, but it's hard to predict at this point.

Tore Egil Svanberg - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

That's very helpful. And if we look at GaN technology in itself, you talked about being, obviously, a landmark for the company. Obviously, today, we're talking a lot about fast charging. But when should we start to see GaN perhaps penetrating some of your other end markets? And can you give us any examples or applications that you're working on right now?

Balu Balakrishnan - *Power Integrations, Inc. - President, CEO & Director*

Sure. We already have a design win on a TV application with a large OEM. Once again, the volumes are starting out small, but that could change very rapidly. We are just about to win a design at a large TV customer in China. We also have an appliance customer in Europe who is designing with GaN for a refrigerator application, primarily because of the efficiency benefits required to meet efficiency standards. So we are actually quite surprised at the interest in GaN across many different applications.



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Tore Egil Svanberg - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

That's helpful. Just one last question for Sandeep. Sandeep, \$175 million in cash coming in. You talked, obviously, about the dividend increase. You talked about reinvesting in the business. How should we think about where that cash eventually is going to go going forward?

Sandeep Nayyar - *Power Integrations, Inc. - CFO & VP of Finance*

I think if you look historically, we've had that 4-pronged approach, which you listed out 2 of them. And we have done selective M&As, I have done buybacks. So I don't -- I think the approach is going to be very consistent with the 4-pronged approach. And again, we're going to do it very opportunistically. We're not going to be in a hurry, but do it very smartly. If you look historically, even on our buybacks, as you know very well, we've been very opportunistic and it's paid us very well. So I don't think we're going to change our approach. And don't expect that for us to do the selective big dividend increases one time. We won't be doing those kind of things.

Tore Egil Svanberg - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Congratulations, again.

Sandeep Nayyar - *Power Integrations, Inc. - CFO & VP of Finance*

Thank you.

Balu Balakrishnan - *Power Integrations, Inc. - President, CEO & Director*

Thanks, Tore.

Operator

Your next question comes from the line of Ross Seymore with Deutsche Bank.

Melissa Weathers - *Deutsche Bank AG, Research Division - Research Associate*

This is Melissa on behalf of Ross. Congratulations on the big litigation win. I guess for the first question, I was wondering if you guys could talk about what you're expecting. I know you don't guide more than one quarter out, but how can we think about seasonality in the Comms segment now that you guys have this big win? And what can we expect in the first quarter?

Sandeep Nayyar - *Power Integrations, Inc. - CFO & VP of Finance*

So that's a good question. And basically, considering that we are gaining share in the rapid charging and cellphone area, you should see a meaningful decline, which is typical in that business. But also, for us, another area that typically comes down is Industrial, which is in the high-power business, because of the infrastructure spend and the budgets being formed. So directionally, I would say that you should see a significant decline sequentially. But on the other hand, I would say, you should see, for next year, directionally, a good sequential increase in Q2 and sequential increase in Q3. We believe that we will outgrow the industry very nicely last (sic) [next] year, not only by the success and the market share gains we are having in cellphone, but by the introduction of new products that I think will start contributing like BridgeSwitch and InnoMux and others.



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Melissa Weathers - *Deutsche Bank AG, Research Division - Research Associate*

Okay. And then on the gross margin guide for next quarter, I apologize if I missed it. But -- so how much of that is being driven by mix? And how much of a drag do you think Comms will be for next quarter? And then sort of what are your expectations for the higher-margin Industrial?

Sandeep Nayyar - *Power Integrations, Inc. - CFO & VP of Finance*

Well, the Comms on a dollar basis between Q3 and Q4, you're not going to see as much change. But as we have talked, seasonally, Q4 is a much better quarter for our Consumer because of air conditioning coming back. And so that is part of the reason, and also a little bit of the higher volumes that we have had is helping Q4. But directionally, if you're looking at gross margin, with the continued success that we are having in rapid charging and the continuous design successes, we believe, next year, from a modeling perspective, the gross margin will be impacted and it should model, as I have talked before, somewhere around 51% for 2020 on a non-GAAP basis.

Melissa Weathers - *Deutsche Bank AG, Research Division - Research Associate*

Okay. Got it. And then one more high-level question. You guys have talked a lot about the -- your competitive advantage with your GaN products. Could you talk a little more about how you're differentiated in your other end markets like industrial and consumer? How do you view the competitive landscape in those end markets?

Balu Balakrishnan - *Power Integrations, Inc. - President, CEO & Director*

Well, GaN is only a part of the technologies we offer. We have InnoSwitch and the number of derivatives of InnoSwitch, like InnoMux and also InnoPro. But we also have products that go into new markets like motor control, which is our BridgeSwitch, which uses its own unique technology. So -- but the fundamental common thread between all of them is efficiency. We offer much higher efficiency than any existing solution, and we also offer the highest integration. That means fewer components, more reliability, which is very attractive in industrial, consumer, computer markets. And, of course, the efficiency is also important to make the adapter small, and that's where we're growing the most at the moment. But the revenue growth will follow in other areas which have a slightly longer design cycle, like in Industrial and Consumer. So it's not just any one technology, it's a combination of technologies that offers them a system-level solution and the benefits that come from the combination of these.

Melissa Weathers - *Deutsche Bank AG, Research Division - Research Associate*

Okay. And congratulations on the solid quarter.

Balu Balakrishnan - *Power Integrations, Inc. - President, CEO & Director*

Thank you.

Sandeep Nayyar - *Power Integrations, Inc. - CFO & VP of Finance*

Thank you.

Operator

Your next question comes from the line of David Williams with Loop Capital.

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David Neil Williams - *Loop Capital Markets LLC, Research Division - VP*

Congrats on the good quarter and the litigation, finally. It's nice that that's come to the end. Just kind of thinking about some of the 5G opportunities in terms of the charging and the battery requirements, we're seeing a few 5G handsets on the market, especially in China, or at least in development. What are you seeing in terms of the power requirements there or what they're adopting? Are you seeing anything that really supports that expanded power expectation that you have?

Balu Balakrishnan - *Power Integrations, Inc. - President, CEO & Director*

Yes. In fact, the 5G will make fast charging even more critical. And the reason for that is the 5G phones will be utilized more continuously because of the bandwidth it provides. There'll be more video downloads and, in general, it will be used more often, which means that you have to charge the batteries. You either have to make the batteries bigger. If you make it bigger, then obviously you need more power to charge it in the same time. So all of that bodes very well for us. So we look forward to even higher power levels in charging cellphones and, therefore, all of our technology will become much more relevant going forward.

David Neil Williams - *Loop Capital Markets LLC, Research Division - VP*

Great. And then just kind of listening to one of your peers, they have noted some pull-in ordering, they thought, for -- specifically on surveillance. But just kind of curious, you saw an uptick here that is typical in the quarter in terms of channel inventory. But are you seeing anything from any specific areas, maybe where there could be some pull-ins ahead of any further trade restrictions?

Sandeep Nayyar - *Power Integrations, Inc. - CFO & VP of Finance*

No, there is no pull-in. It is -- for us, the little increase that popped in was because of some design wins that we had on the Communications segment, and that's where the distis had to satisfy that. It's just a timing issue. And -- but as you know, there is always, during this time, a little uptick. So for us, it's not anything unusual, considering how much our inventory had dropped in the last couple of weeks in the channel -- I mean, last couple of quarters.

David Neil Williams - *Loop Capital Markets LLC, Research Division - VP*

Okay, very good. And then just one last one here. If we're thinking about the BridgeSwitch, which you mentioned for the motor control, and just kind of given the Industry 4.0 evolution that's expected to happen soon, and that's really centered around the efficiency. How do you think you can perform in that market? I guess, longer term, what are your expectations, specifically for the BridgeSwitch solution and the motor control as a whole?

Balu Balakrishnan - *Power Integrations, Inc. - President, CEO & Director*

Well, many countries have very strict regulations on efficiency, which continue to get tighter every year. So what is happening is that things like washing machines, dishwashers and refrigerators, there are new efficiency requirements that force them to go into BLDC, our brushless DC motors that require electronic motor control, which is where the BridgeSwitch provides a solution. What is surprising to us is even things like water pumps in a dishwasher, which is used infrequently, are going to BLDC. They used to be just either DC motors or AC motors, but now they're going to brushless DC motors just to get that additional efficiency. And also, there are some other benefits the brushless DC motors bring like reduced noise and so on. But the biggest area is in refrigeration and air conditioning, where the motors run continuously and, therefore, the efficiency becomes extremely critical. Even a little bit of improvement in efficiency allows them to have lot more margin in other areas to meet the efficiency requirements.



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Operator

(Operator Instructions) Your next question comes from the line of Christopher Rolland with Susquehanna.

David Wayne Haberle - *Susquehanna Financial Group, LLLP, Research Division - Associate*

It's David Haberle on behalf of Chris, tonight. I guess, first, from a bit of a higher level, can you talk about the linearity of orders in the September quarter, and what you've seen thus far in October? Because your guide seems flat. It might be a little better than some others we've heard so far in this earnings season.

Sandeep Nayyar - *Power Integrations, Inc. - CFO & VP of Finance*

So for us, the quarter began with the backlog at the beginning a little lower, so the turns that we need -- compared to the previous quarter. So the turns we need is slightly higher, somewhere around high 30s. But as we have talked about the design wins that we've been having, the success we're having in rapid charging, our guide reflects. And then also the seasonal uptick that we get in air conditioning is reflective in our guidance.

Balu Balakrishnan - *Power Integrations, Inc. - President, CEO & Director*

And I would also like to add that the bookings in October, this month, have been stronger. And so that's also -- is used in calculating our guidance.

David Wayne Haberle - *Susquehanna Financial Group, LLLP, Research Division - Associate*

Got it. And then I have 2 quick ones on the GaN product. Is there a wattage threshold where you just see that GaN is such a no-brainer for OEMs in terms of advantages? I guess, for example, in like a 15-watt charger, are you competing with GaN in your traditional product there and just offering both to customers? And what are they choosing?

Balu Balakrishnan - *Power Integrations, Inc. - President, CEO & Director*

Well, generally, GaN becomes interesting at 30 watts and above, almost independent of the application. But there is also a higher cost associated with GaN. GaN is more expensive, but at a system level, it offers a number of advantages in terms of size, efficiency, lack of heatsink and so on when you go to higher power levels. I think in the long run, we see GaN becoming very prevalent about the 30 -- roughly 30 watts and above. We think we have, by far, the best GaN technology, which is a totally proprietary technology, very different from everybody else. And I think that we are the only company shipping GaN in high volume, even though there's been talk about GaN for a long time, as far -- going as far back as 15 years. But if you look in the market, it's hard to find any commercial product using GaN until we started shipping in high volume. And so I think that's where the benefit is. We have a very cost-effective GaN. We have a GaN that is proven in the market. And so we think we're in a very strong position to transition from silicon switches to GaN switches over a period of time, over the next few years.

David Wayne Haberle - *Susquehanna Financial Group, LLLP, Research Division - Associate*

Got it. Very helpful. And then one last one for me. I know a lot of the GaN stuff is aftermarket right now. But as you think about going into kind of the next year, how do you think about split between aftermarket versus inbox? Where do you think that's ultimately going to shake out?

Balu Balakrishnan - *Power Integrations, Inc. - President, CEO & Director*

Well, that's a good question. Right now, I would say the aftermarket is relatively small. It's not very significant compared to the overall OEM market. Having said that, number of OEMs that are actually looking at GaN as we speak, when they come out with GaN, it will generally be on the higher end of their phones. So the volumes will have to gradually grow because of the higher price of the product. But then if you want to go to something



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like 45, 50 watts, there is really no other way to do this and have the size reasonable. People don't want to carry big bricks for their cell phones. And if you want to make it a small adapter, you really don't have much of a choice. And we hope that the increase in power will drive more OEMs into the GaN technology.

Operator

There are no further questions in queue at this time. I turn the conference back over to our presenters.

Joe Shiffler - Power Integrations, Inc. - Director of IR & Corporate Communications

Okay. We'll leave it there. Thanks, everyone, for listening. There will be a replay of this call available on our investor website, which is investors.power.com. Thanks again for listening, and good afternoon.

Operator

This concludes today's conference call. Thank you for your participation. You may now disconnect.

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