

Power Integrations
Second Quarter Results Call
July 29, 2014

Joe Shiffler: Thank you, Mike. Good afternoon everyone and thanks for joining us to discuss Power Integration's financial results for the second quarter of 2014. With me on the call are Balu Balakrishnan, President and CEO of Power Integrations, and Sandeep Nayar, 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.powerint.com for an explanation of our reasons for using such non-GAAP measures, as well tables reconciling these measures to our GAAP results. Also, our discussion today including the Q&A session will include forward-looking statements, reflecting Management's current forecast of certain aspects of the Company's future business. Forward-looking statements are denoted by such words as will, would, believe, should, expect, outlook, estimate, anticipate, project, potential, forecast and similar expressions that look towards 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 under the caption Item 1A Risk Factors in Part 2 of our most recent Form 10-Q filed with the SEC on May 5th, 2014.

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And now I'll turn the call over to Balu.

Balu Balakrishnan: Thanks, Joe, and good afternoon. Our second quarter results were on target with \$89 million in sales and better than expected gross margins, resulting in strong earnings and more than \$26 million in cash flow from operations. We also made good use of our cash, continuing our disciplined, opportunistic approach to capital allocation. We were confident that our disappointing Q1 results were a function of short-term market disruptions and that our long-term growth story was firmly intact. With that in mind, we viewed the pullback in our share price as an opportunity and deployed more than \$25 million during the quarter to buy back stock at an average price of less than \$50 per share. We also added \$50 million to our buyback authorization and increased our quarterly dividend by 20%.

Our Q2 results demonstrate that our confidence was well placed. Revenues grew 7% sequentially, led by the consumer market, where we saw double-digit sales growth on strength in appliances and consumer electronics. Appliances continue to be a key growth driver, reflecting the reliability benefits of our highly integrated products as well as our expanding silicon content driven by energy efficiency standards and increasing penetration of electronic control in home appliances.

In percentage terms, computing was our fastest growing end market with revenues up nearly 20% sequentially, returning to roughly the same level as before the last quarter's supply chain hiccup. Notably, for the first six months of the year our computing revenues are up 15% from last year, reflecting significant market share gains in both main and standby power supplies for PCs.

Industrial revenues increased mid-single digits sequentially, driven by broad-based demand in traditional industrial applications, such as process control and motor control, as well as newer applications like smart meters, LED lighting and IGBT drivers for industrial motors and renewable energy systems.

Revenues from the communications end market were down high single digits sequentially, as we saw lingering softness at a key customer in residential networking, as well as lower demand related to our largest end customer in cell phone chargers. However, we expect improvement in the communications market in the second half of the year, driven by a recovery in networking applications as well as the initial ramp of rapid charge design for smartphone market.

In Q2, we shipped our first production quantities of ICs for Quick Charge enabled chargers for a Chinese handset OEM and we expect that business to continue ramping in Q3. We expect a more substantial contribution from rapid charging in Q4 as we begin shipping into high-volume rapid charging designs for additional end customers.

Before I turn it over to Sandeep, I'd like to touch on another positive development in our patent litigation against Fairchild Semiconductor. Last month a federal district court in Delaware issued a permanent injunction against approximately 80 Fairchild products that were found to infringe on our patents in a 2012 jury verdict. Any additional products containing the infringing features are also subject to the injunction. This is the second permanent injunction we have obtained against Fairchild, bringing the total number of enjoined products to more than 180. This decision follows the jury verdict we received earlier this year in California in which approximately 140 Fairchild products were found to infringe, and we were awarded damages of \$105 million. We are now seeking a permanent injunction against those infringing

products, and treble damages based on the jury's finding of willful infringement. In all, Fairchild and its System General subsidiary have now been found to infringe our patents on four separate occasions, including in some cases repeated violations of the same patent. Fortunately, it appears that justice is running its course and we hope these recent court decisions will encourage Fairchild to re-think their long-running disregard for our intellectual property rights. With that, I'll turn it over to Sandeep for a review of the financials.

Sandeep Nayyar: Thank you and good afternoon. Since the results are very straightforward, I'll just do a quick review of the Q2 numbers and the outlook, and then we will open it up for questions. I will focus my remarks primarily on the non-GAAP numbers which are reconciled to the corresponding GAAP numbers in the tables accompanying our press release.

Second quarter revenues were \$89 million, up 7% sequentially and squarely in the middle of our forecasted range. On a year-over-year basis, revenues increased 1% against last year's very strong second quarter. With more favorable comparisons ahead of us, and several new products ramping, we expect an acceleration in our year-over-year growth rates over the next several quarters. Revenue mix for the second quarter was 38% consumer, 35% industrial, 15% communications, and 12% computer. Seventy-eight percent of revenues in the quarter were on sales through distributors, while 22% of sales were direct.

Non-GAAP gross margin for the quarter was 55.8%, down 60 basis points versus the prior quarter, but better than our forecast reflecting favorable end market and product mix. Our gross margin expectations for the balance of the year and particularly for Q4 reflect a somewhat less favorable end market mix as well as increased revenues from new products, which tend to carry lower than average margins early in their life cycle.

Non-GAAP operating expenses for the quarter were \$29.7 million, up \$1.3 million from the prior quarter, reflecting annual salary increases which took effect April 1st, as well as headcount additions and accelerated R&D spending related to new products. Non-GAAP operating margin for the quarter was 22.4%.

Our GAAP tax provision included a benefit of \$3.3 million in the second quarter, stemming from the completion of our tax audit for the years 2007 through 2009. We have excluded this benefit from our non-GAAP results, giving us a non-GAAP tax rate of 6.2% for the quarter, essentially flat from the prior quarter.

Non-GAAP earnings for the quarter were \$0.61 per diluted share, up \$0.05 from the prior quarter. GAAP earnings, including the tax benefit, were \$0.54 per diluted share.

We generated \$26.2 million of cash flow from operations in the quarter, while capital expenditures totaled \$5.4 million.

Cash and investments on the balance sheet totaled \$212.4 million at quarter end, down about \$5 million during the quarter, reflecting share repurchases totaling \$25.7 million. As Balu noted, the average price of shares repurchased in the quarter was just less than \$50. Since initiating our latest repurchase program in late 2012, our average purchase price is approximately \$39 per share. At quarter end, we had roughly \$54 million remaining on our buyback authorization, including a \$50 million increase we announced in May. Also, as we announced last quarter, our quarterly dividend will increase by 20% to \$0.12 per share beginning in the third quarter.

Internal inventories increased by \$3.3 million during the quarter but declined slightly in terms of days from 118 days to 116 at the end of Q2. That's well within our target range of 110 days plus or minus 15.

Turning to the outlook, we expect third-quarter revenues to be in the range of \$92 million to \$97 million, an increase of roughly 3% to 9% sequentially. We expect non-GAAP gross margin for Q3 to be in the range of 55 to 55.5%, down slightly from Q2, reflecting a modest incremental contribution from recently introduced products, as well as less favorable end market mix driven by an expected recovery in the communication market. We expect both of these factors to have an even greater impact in the fourth quarter, likely resulting in a somewhat more pronounced impact on gross margin, accompanied by a better-than-seasonal top-line increase.

For operating expenses, I expect non-GAAP opex to be flat to slightly lower in the third quarter compared to the second quarter, and to remain at similar levels in the fourth quarter. Lastly, I expect the non-GAAP tax rate for the balance of the year to be approximately 7%. With that, I will turn it back over to Joe.

Joe Shiffler: Thanks, Sandeep. We'll open it up now for the Q & A session. In the interest of time I'd like to ask our callers please to stick to a limit of two questions at a time. Time permitting, we'll certainly be happy to come back around for additional follow-ups. Now, Operator, would you please give the Q&A instructions?

Operator: At this time, I'd like to remind everyone in order to ask a question, press star, one, on your telephone keypad. We will pause for a few moments to compile the Q&A roster. The first question is from Ross Seymore with Deutsche Bank.

Ross Seymore: I guess one backward looking, then one forward looking. Can you talk a little about what was going on on the comms side? I know you mentioned networking was still weak and then one big customer, but any more details you can give there and what gives you the confidence that that's actually going to snap back?

Balu Balakrishnan: So there were two issues. One on the networking side as you mentioned, and that customer was actually a little bit lower than we expected in Q2 because they still had some inventory left over. However, we now know they have cleared their inventory and they will come back in Q3, not to the original levels but they will come back to recover from where they were in Q2. And in cell phones, our largest customer reduced their forecast further in Q2, so again, they were down more than we originally anticipated.

Ross Seymore: As far as the snap back goes, though, when you talk about comms, it seems like that's a big driver into the back half of the year. Can you give us any help on kind of magnitudes? After a couple quarters of disappointments, why do you think your biggest customer would come back, if in fact that's part of your guidance?

Balu Balakrishnan: That's an excellent question. The reason we think we will do well in cell phones is because of new designs. These are the rapid charge designs that will go into production - pre-production in Q3 and also into production ramp in Q4 for this specific customer. So that's where the growth is going to come from in the cell phones. In the networking, of course, they're going to recover because they have to buy more products now.

Ross Seymore: Great. Thank you.

Balu Balakrishnan: You're welcome.

Operator: The next question is from Steve Smigie with Raymond James.

Vince Valentine: Hi, thanks. This is Vince Celentano calling for Steve. I was wondering going forward, does it seem like the appliance business is still looking like a 9% annual growth business?

Balu Balakrishnan: I can't predict exactly how fast it will grow, but we definitely see that as a growth area for us because of the fact that we mentioned earlier, which is the electronic content is growing, and also number of appliances that have electronics is growing rapidly, and so because of those two reasons, we are doing really well in appliances.

Vince Valentine: Okay, great. And now in the LED market, I was

wondering if you can talk a little about your share in that market and what are the growth drivers you're seeing right now?

Balu Balakrishnan: In the LED market, the best we can estimate - and it's a really difficult estimate because the total number of LEDs sold are always changing, but to the best we can estimate, our share is in the low teens. That's our best estimate.

Vince Valentine: Okay, great. Thank you.

Balu Balakrishnan: You're welcome.

Operator: The next question is from Andrew Huang with Sterne Agee.

Andrew Huang: Thanks for taking my question, guys.

Balu Balakrishnan: You're welcome, Andrew.

Andrew Huang: I guess the first question is, I think up until now you've never really talked about which customers you have for Quick Charge, but it seems like today, you're giving—you're being a little bit more specific. Is that a correct interpretation?

Balu Balakrishnan: Well, I think we have said that we have won—you know, three designs in...

Andrew Huang: Right.

Balu Balakrishnan: And one of them is actually in—going into full production in Q3. It's a Chinese company. There are more going into production or ramping into production in Q4. That's why we think Q4 is going to be seasonally stronger than usual.

Andrew Huang: And did you say that one of those ramping in Q4 is your biggest OEM customer as well?

Balu Balakrishnan: I believe I did.

Andrew Huang: Okay. Then I guess the second question I have as a follow-up is, I think on the last earnings call, you talked about this new technology where you're integrating the primary and secondary stages. So maybe you could talk a little bit more about that and when you think that could impact revenue?

Balu Balakrishnan: Yes, let me correct that. Let me make sure I said the

right thing. For the design that is ramping, it's a rapid charge design. That's what I was talking about earlier.

As far as the new product, that has both primary and secondary integrated onto the same chip, that one is actually in production. It shipped as we expected, between half a million to 1 million—we were actually closer to 1 million in Q2—and it will continue to ramp in Q3 and we'll see a more accelerated growth in Q4.

Andrew Huang: Is that particular product again for the cell phone market or is not for the cell phone market?

Balu Balakrishnan: It's actually for all of the markets we are in for the power level it serves, but our first entry is into the cell phone market because it is a very good fit for the rapid charging application. So we chose to introduce that product first into that market, but we do plan to introduce that more broadly, probably later in the year or the beginning of next year to other markets.

Andrew Huang: Thank you, and I'll go back into the queue.

Balu Balakrishnan: Thanks, Andrew.

Operator: Again, if you would like to ask a question, press star, one. The next question is from Tore Svanberg with Stifel. Your line is open.

Tore Svanberg: Yes, thank you. I guess the first question, Balu, I was hoping you could elaborate a little bit on this better-than-seasonal Q4. It does sound like you've got rapid charge ramping. I'm just trying to understand if there's any other, you know, moving parts for that quarter and, you know, if we're now basically looking at moderate growth or should we expect something more material than that?

Balu Balakrishnan: Rapid charge is one component of that, but we also have other new products, like Link-HP and also the recently introduced lighting products that we will see growth then in Q4 as the designs go into production, so it's really a number of our new products. Plus, of course, all of our growth drivers will continue to help us in Q4. But from a seasonality point of view, the new products are the ones that are going to give us the most seasonal growth, and our expectation is that the growth will be in the low to mid single digits relative to Q3.

Tore Svanberg: Very good. Thank you. As my follow-up, I believe the US DOE is coming out with a new efficiency regulation in early 2016, and I believe you recently came out with a product, a LinkSwitch product that actually meets those criteria. I was hoping you could talk a little bit about that and if that's something that could potentially even have an impact on your business in 2015.

Balu Balakrishnan: Yes. The DOE standard is called the DoE 6.0, goes into effect January of 2016, and it dramatically tightens the efficiency requirements and no-load requirements for the external power supplies. The new product I just mentioned which combines primary and secondary into a single package—we call it a revolutionary topology—that easily meets this requirement today, and so that's one of the reasons it will be used—we believe will be very successful in adapter applications which are external power supplies.

The LinkSwitch-3 that we announced also meets the DoE requirements, DoE 6.0 requirements. That goes into lower power levels, 5 watts and below, whereas the new topology, our new product goes in the, you know, 7 watts and above all the way up to about 25 watts.

We also have other products that can meet DoE requirements, so we are well prepared to take advantage of this new standard, and we do expect a positive impact on our growth next year because of this DoE standard.

Tore Svanberg: Thank you, Balu, and congratulations on the results

Balu Balakrishnan: Thanks, Tore.

Operator: Your next question is from Andrew Huang with Sterne Agee.

Andrew Huang: Thanks. When you talk about Q4 and the better-than-seasonal, when I think about the operating expenses that go along with those incremental revenues, have those already been spent and should I assume that opex is going to be flattish still in Q4 relative to Q3?

Sandeep Nayyar: Yes, Andrew, so—this is Sandeep. Basically, if you see what happened in Q2, we accelerated some spending on R&D for the new products and that's why we had—and that's why I think the expense for the rest of the year will be kind of flat to slightly down from the Q2 levels.

Andrew Huang: Got it.

Balu Balakrishnan: What we specifically said was they'll be slightly down in Q3, and in Q4, we'll be roughly flat to Q2.

Andrew Huang: Okay. Got it. Then I guess going back to LED lighting, I think I've asked this question in the past, but are you seeing any trend towards like an LED light bulb versus LED fixtures, and do you have any kind of bias towards one or the other?

Balu Balakrishnan: Not necessarily a bias but definitely we are seeing a bifurcation of that market where the LED bulbs are very high volume, also we have more concentrated customer base; because by definition, the only way to get the LED bulbs to a very low price is by manufacturing them in very high volumes. So we are kind of seeing the split where we have a higher volume lower margin bulb business, and a lower volume but higher margin and much more fragmented fixture business.

Andrew Huang: Okay. So if you don't mind me asking, would you characterize your LED business, the margins there being in line with corporate average, below or above?

Balu Balakrishnan: If you take the LED business as a whole, it is definitely above our corporate average.

Andrew Huang: Thank you very much.

Balu Balakrishnan: You're welcome.

Operator: There are no further questions at this time. I will turn the call back over to the presenters.

Jeff Shiffler: Okay. Thanks everyone for listening. There will be a replay of this call available on our website, investors.powerint.com. Thanks again for listening and good afternoon.