

**Power Integrations, Inc.**  
**Third Quarter 2014 Financial Results Conference Call**  
**October 30, 2014**

**Operator:** Good afternoon. My name is John and I will be your conference Operator today. At this time I would like to welcome everyone to the Power Integrations Third Quarter Results Conference Call. All lines have been placed on mute to prevent any background noise. After the presenters' remarks there will be a question-and-answer session. If you would like to ask a question during this time, simply press star then the number one on your telephone keypad. If you would like to withdraw your question, press the pound key. Thank you.

Mr. Joe Shiffler, Director of Investor Relations. You may begin your conference.

**Joe Shiffler:** Thank you. Good afternoon and thanks for joining us to discuss Power Integrations' financial results for the third 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.powerint.com](http://investors.powerint.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 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 in Part 2 of our most recent Form 10-Q filed with the SEC on July 31st, 2014.

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Now I'll turn the call over to Balu.

**Balu Balakrishnan:** Thanks, Joe, and good afternoon. Our revenues and earnings increased sequentially but we observed a slowdown in orders as the quarter progressed, resulting in less than seasonal top line growth. Revenues from the communications end-market grew more than 20% sequentially, driven by strength in mobile phone chargers and renewed demand from a large Asian customer in the residential networking space. However, demand was softer than expected in the industrial, consumer and computing markets, all of which were predominantly through—all of which we serve predominantly through the distribution channel. Overall, distribution sales decreased by nearly 5% compared to the prior quarter.

From a bookings standpoint, after a strong July, orders declined in August and again in September resulting in a sequential decline in total bookings for the quarter and a lower starting backlog for the fourth quarter compared to Q3. Orders in October have remained lackluster. These trends are not what we typically see at this time of the year and not what we anticipated three months ago when we gave our Q3 outlook. Of course we have noted the negative tone of some recent economic data and commentary from certain of our industry peers suggesting that macro or cyclical factors may be weighing on the demand.

Taking these factors into account, we are forecasting fourth quarter revenues of \$86 million plus or minus \$3 million. The midpoint of that range would be a mid-single digit decline, consistent with the forecast given by many of our peers. While our near-term outlook reflects the uncertainty of the current demand environment, our profitability and cash flow remain healthy and our balance sheet remains as solid as ever.

We reported a non-GAAP operating margin of 23% for the third quarter due in part to a gross margin that remains at the high end of our target range and thanks also to a significant reduction in operating expenses. We expect opex to rise in Q4 mainly to patent litigation expenses but otherwise plan to manage spending carefully in light of the current demand environment. We generated more than \$30 million in cash flow from operations in the third quarter and added cash to our balance sheet despite using more than \$20 million for share repurchases and dividends. Our dividend increased to \$0.12 per share in the third quarter and this month our Board approved a \$25 million increase in our buyback authorization, reflecting our continued confidence in the long-term prospects of our Company.

We have expanding addressable markets, a strong pipeline of innovative products with which we serve these markets and a tailwind created by the growing demand for energy efficiency and renewable energy. Over the past five years we have broadened our focus from low power applications like adaptors and standby power supplies, to a wider range of power conversion applications ranging from milliwatts to megawatts of output, and

spanning the clean power ecosystem from the generation and transmission of energy to the efficient consumption of power, in everything from electronics to lighting to heavy industry. As a reflection of this ongoing evolution, we have developed a new corporate brand identity which we plan to unveil in the coming weeks.

Our new look will feature an updated logo emblematic of our unparalleled expertise in power conversion. We will also launch a new website and a new web address, power.com, shining a brighter light on the breadth of our product offerings and technical know-how and signaling our ambitious long-term strategic and financial goals. We're excited about this important symbolic step for our Company and we look forward to rolling it out in the weeks ahead.

Now I'll turn it over to Sandeep for a review of the financials.

**Sandeep Nayyar:** Thank you and good afternoon. I will quickly go over the third quarter results 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.

Third quarter revenues were \$90.1 million, an increase of 1% from the prior quarter. Sales into the communication end-market rose more than 20% sequentially, reflecting strength in mobile phone charges and residential networking. However, as Balu noted, sales into the other three end-market categories reflected the broad slowdown in orders that occurred from August onwards. Revenues from the consumer market, our largest category, were down mid-single digits while sales into the computer market declined low single-digits and sales into the industrial market were flat. Revenue mix for the third quarter was 36% consumer; 35% industrial; 18% communication; and 11% computer. Seventy-four percent of revenues in the quarter were on distribution sales while 26% of sales were direct. That's a change from a 72—78 to 22 ratio last quarter, reflecting the relative softness of the distribution business and the strength in communication where we tend to serve directly to high volume customers.

Non-GAAP gross margin for the quarter was 55.3%, in the middle of our forecasted range. Non-GAAP operating expenses for the quarter were \$29.1 million, down more than \$600,000 from the prior quarter, largely reflecting expense controls we have implemented in light of the weaker demand environment. Non-GAAP operating margin for the quarter was a solid 23%. Non-GAAP earnings were \$0.65 per diluted share, up \$0.04 from the prior quarter. Our weighted average diluted share count was 30.76 million shares, down more than 1% from the prior quarter, reflecting buyback activity. We

bought back 359,000 shares during the quarter, utilizing \$19.5 million and leaving roughly \$34 million remaining on our buyback authorization at quarter-end.

Buyback activity accelerated after the early October pullback in our share price, and as Balu noted, our Board of Directors has allocated an additional \$25 million for repurchase activity. Despite the buyback activity that took place in Q3, cash and investments on the balance sheet increased slightly during the quarter thanks to strong operating cash flows of \$30.6 million. Capital expenditures in the quarter totaled \$7.5 million. We also paid out \$3.6 million in dividends as our quarterly dividend increased to \$0.12 per share. Inventories increased by \$5.7 million during the quarter, reflecting the lower than expected demand. That's 126 days of inventory, up from the last quarter but still roughly in line with our targeted range of 110 plus or minus 15 days.

Turning to the outlook, we expect fourth quarter revenues to be in the range of \$86 million plus or minus \$3 million, a decrease of between 1 and 8%. We expect non-GAAP gross margins to be approximately 54%, down from the third quarter, reflecting a less favorable end-market mix and a slightly larger contribution from newer products which carry lower than average gross margin at this stage of their life cycle. Non-GAAP operating expenses should be between 29.5 and \$30 million, with the increase from Q3 driven largely by higher litigation expenses, reflecting the timing of activity in one of our ongoing patent suits. Lastly, I expect the non-GAAP effective tax rate to remain in the range of 6 to 7% for the fourth quarter.

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

**Joe Shiffler:** Okay we'll open it up now for questions-and-answers. John, would you please give the instructions for the Q&A session.

**Operator:** Certainly. At this time I would like to remind everyone that in order to ask a question, press star then the number one on your telephone keypad. We'll pause for just a moment to compile the Q&A roster.

Your first question comes from the line of Tore Svanberg from Stifel. Your line is open.

**Evan Wang:** Yes, hi. This is Evan Wang calling in for Tore. Thank you for taking my question.

**Balu Balakrishnan:** Hi Evan.

**Evan Wang:** Hi. My first question is about your communications business, it was up very nicely. I was wondering if you have any 10% customer during the quarter as a result of the ramp?

**Balu Balakrishnan:** No, we don't.

**Evan Wang:** Okay and I was wondering if you have any visibility—I know you won't guide for the March quarter but do you have any visibility into what—how that might look like? Following (cross talking).

**Balu Balakrishnan:** How the communications market would look like?

**Evan Wang:** No, the overall business, all the end markets.

**Balu Balakrishnan:** For which—you're talking for which quarter, Q4 or March?

**Evan Wang:** (Cross talking) well if you could actually give us more of a sense of what the fourth quarter might be driven by, as well as how do you see the March quarter shaping up?

**Balu Balakrishnan:** So it's hard for us to have visibility into which markets will do well in the Q4 quarter because most of our revenues go through distribution. However, we do have visibility, more visibility I should say into the communications market because a lot of the customers there we sell directly to. Our expectation is the communication market will do better overall as a percentage compared to the total revenue, and that's because of our growth in rapid charging.

**Evan Wang:** About the March quarter, I think, is it likely to be a seasonal quarter or do you see the potential for doing better than seasonal?

**Balu Balakrishnan:** It's really too early to tell. The decrease in bookings we've seen in the last three months starting in August has been a very big surprise to us and so we are not quite sure exactly what to expect for the rest of the year and definitely not for the 2015. We'll just have to wait and see how things go.

**Evan Wang:** Okay, great, thank you very much.

**Balu Balakrishnan:** You are welcome.

**Operator:** Your next question comes from the line of Steve Smigie from Raymond James. Your line is open.

**Vincent Celentano:** Thanks. This is Vince Celentano filling in for Steve. I want to see, going into 2015, I want to see what drivers you see in appliances and what overall level of growth do you think you can achieve?

**Balu Balakrishnan:** Well, appliances has been a very strong market for us. We've been growing consistently except for the recent downturn which seems to be very broad-based from everything we can tell, both not only in the appliances but also in industrial. Having said that, our content in appliances has been growing, especially because of the new energy efficiency requirements. We see growth in CAPZero, SENZero and LinkZero products because many of the appliance customers are asking for no consumption during standby. So we see that as a growth market as long as the macro is supportive of that.

**Vincent Celentano:** Okay, great and then now going into LED. Same question as far as going into 2015, any color as far as where the growth potential and what drivers through 2015?

**Balu Balakrishnan:** So first of all, in Q3 the LED market declined particularly more than other markets in the industrial sector. I think that's something that is consistent with what was reported by number of companies. We think it is a short-term issue. We expect the LED market to be a long-term growth factor for us. It looks like, from everything we can tell, it's still the best lighting technology and with the incandescent being phased out in most countries, we believe LED will be the ultimate winner in the lighting market. Exactly how it will grow is yet to be seen. We are a little bit surprised and disappointed that this year will be a relatively small growth. But it's very possible that will come back to a stronger growth next year.

**Vincent Celentano:** All right, great, thank you.

**Balu Balakrishnan:** You are welcome.

**Operator:** Again, if you would like to ask a question, that's star then the number one on your telephone keypad. There are no additional questions in the audio queue. I'll turn the call back over to the presenters.

**Joe Shiffler:** Why don't we give a few seconds longer here in case anyone else would like to ring in with a question? If there are no further questions, which it looks like—looks like we do have some questions coming in, is that correct?

**Operator:** Yes, that is. Your next question comes from the line of Tore Svanberg from Stifel. Your line is open.

**Evan Wang:** Thank you. Hi, I have a follow-up question I was wondering if you can give us a little bit more color on what you're seeing with your distributors right now. Are the orders weaker because of inventory in the channel or is it because your lead times are really short? I was just wondering if you can give us a little more color on the dynamics there.

**Balu Balakrishnan:** Well I think the inventory at distributors is higher than normal mainly because of the sudden slowdown in demand and our expectation is they will burn that through the next few months. But other than that, we don't have any other visibility. Obviously we get visibility into where they ship only after we get the POS at the end of the quarter and so we don't have that much information other than the general broad slowdown that you've seen in the last few months.

**Evan Wang:** Okay, thank you.

**Operator:** Your next question comes from the line of Gus Richard from Northland. Your line is open.

**Gus Richard:** Hey, thanks for taking the question. Just real quick one, what is the—your litigation expense is going to be up in the quarter. Can you just give a little bit more color as to how much that is?

**Sandeep Nayyar:** So this last quarter we did about roughly \$1.5 million and I think it'll be about 300,000 to 400,000 more, roughly.

**Balu Balakrishnan:** In Q4.

**Gus Richard:** Okay and what was it in Q3, I'm sorry?

**Balu Balakrishnan:** It's roughly about 1.5 million.

**Gus Richard:** Got it. Is that lit coming to an end or is this just a new round at the beginning?

**Sandeep Nayyar:** Well, this is just one of the cases, and that's why we have said for going forward, you know, if you look at it on an annual basis for modeling purposes, to still keep it in the 6 million to 6.5 million for the full year.

**Gus Richard:** Right (audio interference) missed the early part of the call. I was just hoping you can give a little bit more color on the weakness in the PC market. Is it just your customers have an inventory correction and the similar question in consumer, can you sort of talk a little bit about where you see the weakness there?

**Balu Balakrishnan:** So as we mentioned in our script, the communications market did very well. It went up 20% but all other markets were flat or down. Industrial was flat and the consumer was down mid single-digits and the computer was down slightly, low single-digits I should say. I don't think there is any particular trend we see. It's just a very broad-based demand reduction. Most of these customers are through distribution and so we see that the

distribution revenue has decreased five percentage points relative to Q2 which—and everything we can tell, that is very broad-based.

**Gus Richard:** Okay, so over the last couple of years, in the first quarter you guys had suffered through an inventory correction in PCs, so is this weakness in the PC or slight weakness, is that foreshadowing further weakness or do you have any further color on what you think is going on in that market?

**Balu Balakrishnan:** That's a good question. It's hard for us to tell. The next few months will be more revealing. We always see things in the rearview mirror so it is difficult to tell whether this is a short-term inventory correction or it is a macro issue or a cyclical issue. We just have to wait and see but it's definitely not something we expected at this time of the year. Usually September and October are very strong months for us, both in terms of bookings and shipments. This time has not been the case.

**Gus Richard:** Got it and the gross margins are holding up quite well in the fourth quarter given the mix should be weaker and I would imagine you're sort of trawling back on the manufacturing. Can you just talk about sort of what's holding it up here?

**Sandeep Nayyar:** Basically as we had—part of the reason that they have been holding up is that the ramp on some of the new products has been a little slower. Added to that, basically we've had a good mix but—till the previous quarter—but this quarter the mix shifted. So in the beginning first half, the mix was more favorable. But as the mix is shifting, you're seeing the gradual decline continuing to happen and you will continue to see that into the next year a little bit, from where we are exiting in Q4.

**Gus Richard:** There's no volume—you're not backing off on what you put into the fab and building?

**Sandeep Nayyar:** No, that is something we're evaluating and as we go through, that could be a headwind in the next quarter depending on how this quarter keeps shaping up so that's the thing we are closely watching and evaluating. Obviously we will be making adjustments if the order pattern continues into the next couple of months.

**Gus Richard:** Okay and just remind me what your inventory target range is?

**Sandeep Nayyar:** Our inventory right now is at—this last quarter we ended at 126 days which is roughly in line with our model [which] is 110 plus or minus 15, so we're somewhere around there. Based on how the slowdown has happened, it could taper up a little bit from there but obviously if the orders continue to be the way we are, we will adjust our production.



**Gus Richard:** Perfect, I really appreciate it. Thanks so much for taking my questions.

**Sandeep Nayyar:** Thank you.

**Balu Balakrishnan:** You're welcome, Gus.

**Operator:** Your next question comes from the line of Sidney Ho from Deutsche Bank. Your line is open.

**Sidney Ho:** Thanks for taking my question and I'm calling in for Ross Seymore. With regards to the guidance of down 1% to 8%, I know you've mentioned earlier that the visibility by end-markets is not that great and also commented that communications would do better. I was just hoping to let you—that you can talk about, is communications actually going to be up in—relative to all the other end-markets which one will be impacted more than the others?

**Balu Balakrishnan:** Well as I said I believe relatively communications will be up in Q4. Exactly which ones will be impacted among the other three markets, it's very hard to tell at this time. I can't think of any specific pattern. The industrial market, depending on which segment of that market has—some of them have some seasonality and others don't, like for example, our high power revenue doesn't have a discernible seasonality. So we'll just have to wait and see. The reason we know the communications will do well is because of the new designs that will be ramping through Q4 specifically in rapid charging.

**Sidney Ho:** Okay, great and then as the follow-up, if I look at your industrial end-market and put an average decline of, call it 5% for next quarter. You look into full year kind of year-over-year, it's kind of flattish versus I think the whole—the rest of the market is probably up, call it 5% to 10%. Is there some trend that we should be looking at—how should we think about next year for industrial?

**Balu Balakrishnan:** I think the industrial should be good next year for multiple reasons. One is in the high power area we are seeing a number of new designs especially in the solar market in China, and that would be a growth factor for us. Also we opened a design center for high power in Germany and the activity in the design center indicates that there is a huge demand for our high power products and a lot of customers are asking for customized designs for their end products. So we are optimistic about that growing.

The other area in industrial is the LED which is the second largest segment and there, after the softness in the second half of this year, our expectations is that it will come back and this year our growth could be relatively small, which is not what we expected but it looks like it's going to be a

relatively small growth this year mainly because of the softness in the second half of this year and if our expectation is right we should grow very nicely in the LED market. So both of them would drive the industrial market because they are number one and number two segments.

**Sidney Ho:** Great, thank you very much.

**Balu Balakrishnan:** You're welcome.

**Operator:** Again, if you would like to ask a question, press star then the number one. Your next question comes from the line of Steve Smigie from Raymond James. Your line is open.

**Vincent Celentano:** Thanks you'd mentioned design wins picking up for rapid charging next quarter. I was hoping you would talk a little bit about that competitive environment around that and what you're seeing?

**Balu Balakrishnan:** So in rapid charging there are obviously a few competitors but I think our product is extremely compelling. The issue is not as much competition as the OEMs deciding what type of rapid charging they're going to choose. There are a number of protocols being offered by vendors which is actually confusing the market a little bit. As you know we offer QC, the quick charge, but we can also support other protocols. There is no—our real product innovation and strength is in the power conversion not in the protocol part. So we can support pretty much any protocol that becomes a standard in the marketplace. But I think the confusion right now is that the OEMs are not sure what protocol to pick. Some of them have already picked the protocols. Some have picked QC; some of them picked a proprietary protocol of their own and so on and so forth.

On top of that, USB standard has issued the next version called the USB PD which has a new cable which allows people to have rapid charging without having to resort to a protocol. The new cable can handle much higher current. So it's possible that will be another contender, a potential winner. The good news is we are very well positioned for that. The higher the current, and the higher the power, the better off it is for us because it's higher content and also our product that we talked about, it will provide extremely high efficiency and the higher the current the more differentiated we are in terms of efficiency. So one way or the other, I think the market will sort it out and we have seen that revenue grow by 100% in Q2 and it could grow 100% in Q3 but probably a little bit less because some of the ramps are delayed because of the confusion I talked about.

Having said that, we did win a major design at a Tier 1 customer that will start ramping at the end of Q4. So all indications are rapid charging will be a growth area for us next year.

**Vincent Celentano:** Okay, great. Thank you.

**Balu Balakrishnan:** You're welcome.

**Operator:** At this time there are no additional audio questions. I turn the call back over to the presenters.

**Joe Shiffler:** Okay, thanks everyone for listening. There will be a replay of this call available on our investor website, [investors.powerint.com](http://investors.powerint.com). Thanks again for listening and good afternoon.

**Operator:** This concludes today's conference call. You may now disconnect.