Power Integrations Inc.

Second Quarter 2015 Earnings Conference Call

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C O R P O R A T E P A R T I C I P A N T S

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Steve Smigie, *Raymond James*

P R E S E N T A T I O N

Joe Shiffler:

Thank you. Good afternoon and thanks for joining us to discuss Power Integrations' Financial Results for the Second Quarter of 2015. With me on the call are Balu Balakrishnan, President and CEO of Power Integration; 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, 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 our most recent Form 10-Q filed with the SEC on April 30, 2015.

This conference call is a property of Power Integrations and any recording or rebroadcast is expressed prohibited without the written consent of Power Integrations. Now I'll turn the call over to Balu.

Balu Balakrishnan:

Thanks Joe and good afternoon. Like many of our industry peers, we experienced softer than expected demand in the second quarter, reflecting global macroeconomic uncertainty as well as challenging conditions in certain end-markets.

Revenues from the computer market declined nearly 10% sequentially in the second quarter, after falling by more than a third over the prior two quarters. Consumer revenues were also softer than expected, declining slightly compared to the prior quarter driven by appliance applications, which account for the majority of the consumer category and exhibited soft demand across both Asian and European customers. Communications revenues increased slightly from the prior quarter as a significant reduction in sales related to Korean end customers was offset by growth in rapid charge designs at Chinese handset customers.

Sales into the industrial end market grew more than 10% sequentially with sales of our high0power IGBT driver products rebounding as expected following a trough in Q1, while LED lighting revenues also grew nicely on a sequential basis.

All in all, second quarter revenues were $85.3 million, up 3% sequentially but below our target range of 5% to 10% growth. Fortunately, the possibility of weaker-than-expected demand became apparent early enough in the quarter that we were able to adjust our operating expenses, coming in about 5% below the mid-point of our projected range.

These expense savings combined with slightly higher-than-expected gross margin enabled us to deliver non-GAAP earnings of $0.47 per share, up from $0.43 in the prior quarter. Cash flow was also strong with cash from operations coming in at $25 million for the quarter.

In view of this strong cash generation, our healthy balance sheet and our belief in the growth potential of our business, our board of directors has authorized a new $30 million share repurchase plan. That follows a quarter in which we bought back more than 1.5% of our outstanding shares and continues our pattern of using our balance sheet to generate value through a combination of carefully targeted M&A, dividends, and buybacks.

While revenues for the quarter were less than expected, demand did improve in the latter part of the quarter with both sales and bookings for the month of June rising significantly compared to April and May.

While macroeconomic trends remain a reason for caution, we believe sequential revenue growth is likely in the third quarter with an expected range of flat to 7% higher compared to Q2. We expect that the primary driver of our growth in Q3 will be the continued ramp of rapid charging designs for the mobile device market.

Rapid charging introduces challenges that power supply designers have not previously confronted in the largely commoditized market for standard low-power chargers. Delivering two, three, or even four times as much power, from an enclosure the same size as that of a traditional charger is a non-trivial task requiring a high level of integration and energy efficiency.

Our new InnoSwitch products are exceptionally well suited for rapid charge applications and we are now in production with InnoSwitch at many of our top-tier handset manufacturers. We believe the requirements for rapid charging and the capabilities of InnoSwitch will enable us to increase our share of the charger market in the years to come with greater dollar content per charger than we have typically earned in low-power chargers.

As discussed in our prior calls, our initial rollout of InnoSwitch products has focused on mobile device chargers because of the immediacy of the opportunity. However, just like earlier flagship product families such as TOPSwitch, TinySwitch and LinkSwitch, InnoSwitch devices address a broad range of power supply applications encompassing hundreds of millions of AC-to-DC power supplies annually. While most of these applications are already served by other product lines, the higher level of integration offered by InnoSwitch not only strengthens our competitive position in this market, but also brings a material increase in our dollar content.

InnoSwitch has already sparked a turnaround in our communications category where the sales are up more than 20% for the first half of 2015 compared to a year ago. We believe it has the potential to accelerate our growth in the other end markets as well beginning next year.

In the consumer market, InnoSwitch has been qualified at two top-tier major appliance manufacturers. We have also now won our first InnoSwitch design in the computing market with an ultrabook charger and in the industrial market, with a UPS power supply design.

Overall, design activity with InnoSwitch is robust, particularly with the new DoE efficiency standards looming, and we expect it to be a significant growth driver in 2016 along with our new LinkSwitch-4 product family which enables low-cost DoE-compliant designs at the lower end of the power scale.

We also look forward to a resumption of growth in our high-power and LED lighting businesses, both of which grew nicely in Q2 after troughing in the first quarter. While currency effects and softness in energy markets continue to be a headwind in the high power, we are seeing strength in the renewable energy markets which accounts for a substantial portion of our high-power revenues.

Meanwhile we have honed our efforts in LED lighting to focus on applications where the reliability, efficiency, and size benefits of our products are most appreciated particularly in commercial and industrial lighting, street lighting and brand-name bulbs.

We continue to devote significant R&D resources to LED lighting and high power, and we have a promising pipeline of new products on the way in both areas, including products that will roughly double that size of our market opportunity in high power, a key synergy of the CT-Concept acquisition that we expect to come to fruition starting in 2016.

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

Sandeep Nayyar:

Thank you and good afternoon. I will quickly cover the Q2 financials and the Q3 outlook and then we will open it up for Q&A. My prepared remarks will focus mainly on the non-GAAP numbers which are reconciled to the corresponding GAAP figures in the tables accompanying our press release.

Q2 revenues increased 3% sequentially to $85.3 million. The industrial end market was the primary driver of growth, increasing more than 10% from the prior quarter. Growth in the industrial revenues was broad-based with high power and LED lighting leading the way.

Communications revenue increased by a low single digit percentage as the continuing ramp of rapid charge design at Chinese handset end-customers was largely offset by softness at Korean end-customers.

Consumer revenues decreased low single digits, reflecting softness in the appliance markets, while revenues from computing applications where down high single digits sequentially.

Revenue mix for the quarter was 36% Consumer, 36% Industrial, 21% Communications, and 7% Computer.

Non-GAAP gross margin for the quarter was 53.1%, unchanged from the prior quarter. That was a bit better than expected, reflecting the relative strength of the higher-margin industrial end-market.

As Balu indicated, we responded quickly to the demand trends we saw in the weeks after giving our Q2 outlook and we took a number of steps to contain expenses. As a result of these efforts, non-GAAP operating expenses for the quarter were $30.2 million, about a million and a half dollars below the midpoint of our forecast. Sequentially that's an increase of just 2% despite the fact that our annual merit increases took effect April 1st.

Continuing down the income statement, other income for the quarter was slightly above zero as interest income was offset by unfavorable currency fluctuations. The non-GAAP tax rate for the quarter was 5.5% resulting in non-GAAP net income of $14.2 million or $0.47 per share.

Turning to the balance sheet, we exited the quarter with $171 million in cash and short-term securities, down about $2 million from the prior quarter. Cash flow from operations for the quarter came in at $25.1 million, while capital expenditures were just under $2 million.

We utilized $22.3 million for share repurchases, buying back approximately 460,000 shares during the quarter. The buyback was particularly active in the later part of the quarter which would result in a lower weighted average share count for Q3.

Less than a million dollars remained on our buyback plan at quarter end, but as Balu noted our board of directors has allocated an additional $30 million for further repurchase.

As in the past, we will make use of a predetermined price/volume matrix that guarantees an inverse relationship between the stock price and the pace of buyback activity.

Inventory on our balance sheet at quarter end was 142 days on hand, a decrease of five days from the prior quarter and that should continue to trend down gradually through the second half of the year, based on our current revenue projection and lower production level.

Channel inventories also decreased during the quarter, falling by nearly a full week to about 6.7 weeks.

Turning to the outlook, we expect revenues for the third quarter to be in the range of flat to up 7% on a sequential basis, driven mainly by growth in the communications market. This should result in a less favorable end-market mix from a gross margin standpoint in addition to the ramp of new products and the effect of reduced production level.

We do expect an offsetting benefit from the effects of the stronger dollar versus the Japanese yen, which reduces our wafer costs. All things considered, we expect Q3 non-GAAP gross margin to be in the range of 52.5% to 53%.

With respect to expenses, we intend to continue managing our spending carefully in light of the uncertain demand conditions. Specifically, we expect non-GAAP OPEX for the September quarter to be roughly $30.5 million which would be at just a slight increase from Q2.

For the year, we are on track for expense growth of just 3% to 4% despite the acquisition of CamSemi in January. Organically, our full year non-GAAP expenses should be roughly flat compared to last year.

Lastly, I expect the non-GAAP tax rate for the third quarter and for the balance of the year to be between 6% and 7%.

With that, I will turn it back over to Joe.

Joe Shiffler:

Thanks Sandeep. We'll open it now for the Q&A session.

Operator:

At this time, I'd like to remind participants in order to ask a question, press star then the number one on your telephone keypad. Your first question comes from the line of Ross Seymore from Deutsche Bank. Your line is now open.

Ross Seymore:

Hi guys and I apologize for juggling a few calls tonight so if it's redundant with what you've already addressed I apologize but, when you look at it as a whole, I can see the comp side is ramping up but it sounds like everything else has been weak. Can you talk a little bit about the trajectory of the bookings you've seen and how much of what you're seeing do you believe is end market inventory burn? I realize you guys recognize revenue on sell-through, but how much of this is inventory verses true demand being weak?

Balu Balakrishnan, *President and Chief Executive Officer*

Well first of all, we actually grew nicely in industrial sequentially. We grew a little over 10% and the consumer market was slightly down primarily because of the appliance being soft, which is very broad based. The PC was the biggest challenge. It was down significantly from Q2 and communications actually grew as you said.

So, in terms of the bookings trends, the April bookings was similar to March but the sell-through in April which we only found out in May, was weak. So, we based our forecast for Q2 on the bookings in April which was quite good and in fact the sell-through in March was very strong so we expected April to be similar to March, but that wasn't the case. So, we decided that—well at the same time we also heard news reports that the PC is continuing to be weak and the Korean OEM still having challenges in the marketplace in terms of demand. So, we decided to cut back on our expenses starting in May.

In terms of bookings in May, the bookings were weak and also the sell-through in May was weak and then June came back actually quite strong. The bookings were very strong in June and the sell-through was also strong in June. So that's kind of the flow. It was May and April bookings was similar and then June was very strong.

Ross Seymore:

How was July?

Balu Balakrishnan:

July is also strong but not quite as strong as June, and our assumption is that because the sell-through was so weak in April and May, our customers' inventories were down so there were also some extra business in June and we are hoping June is a recovery from the macro, but it's hard to tell with one month, but July is quite strong and we are cautiously optimistic that we are coming out of this downturn.

Ross Seymore:

I guess a couple more precise questions; I know you discussed the rapid charge design wins at the China handset makers offset some of the weakness in Korea, but some of the data points we have been seeing about China handset market itself being weak, does that give you any pause looking forward as far as how those different customer bases can offset each other?

Balu Balakrishnan:

Well, since we are getting into this rapid charging market, it doesn't necessarily correlate directly with the overall health of the Chinese cellphone vendors. All of our projections show that our rapid charging revenue will continue to grow in Q3 and Q4 and onwards. So, we are quite bullish about that market. Our bigger concern is the overall macro that will affect broadly all markets.

Ross Seymore:

Okay. Then the last one more of a housekeeping one. I know you guys authorized another $30 million share repurchase program. Can you just tell us how much cash you have onshore currently?

Sandeep Nayyar:

Majority I would say you know, a bulk of the cash is onshore.

Ross Seymore:

Great. Thank you very much.

Joe Shiffler:

Thanks Ross.

Operator:

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

Tore Svanberg:

Yes, thank you. A first question is on rapid charge. I was hoping maybe you could talk a little bit more specifically about USB-C and if that's an area where probably you're starting to see some traction at this point? Or you know power delivery, USB PD or USB-C, either—either one.

Balu Balakrishnan:

Yes. From what we can see, it sure looks like the Quick Charge is the most cost-effective current solution but USB-PD is going to be the long-term solution for fast charging. Most of the OEMs are seriously considering going to USB-PD for more than one reason, one of them being that it has a very small connector, the type C connector, and the second one being it can deliver a lot of power. Even without any protocol it can deliver a lot of power but with the USB-PD protocol, the cable can deliver up to 100 watts of power which is a very significant you know advantage if you're going to larger devices like notebooks.

Tore Svanberg:

Very good, and as my follow-up question, you talked about industrial being up very nicely for you in the June quarter. I am just wondering how that's looking, not necessarily just for September but maybe for the whole second half because my understanding is that you have some new products and new programs ramping so if you could just add some color on that, that'd be great.

Balu Balakrishnan:

So, that's always a challenge because our bookings don't tell us where the products go but I would say that if you look at our industrial, there is three different buckets. There is the high-power, there is LED and there is rest of the industrial market. The rest of the industrial market generally correlates with what other companies see and some companies also put the appliances in industrial market and that may be the reason they are not doing as well in industrial.

As far as we are concerned, we have growth in all three of them, although the growth was highest in the high-power and the LED market. Our long-term thinking is that we will grow in high-power and LED, we will also grow in the other miscellaneous markets especially in power tools and smart meters, and also industrial controls. But, it's very hard to project on a quarterly basis exactly what's going to happen, especially with this macro issues that we are seeing, which I am hoping is going away but we don't know that for sure.

Tore Svanberg:

Great. Just one last question, I was hoping you could also update us on the integrated power, talking specifically about new—potential new versions of InnoSwitch, if you have gotten some good customer response there and when we could start to see some more meaningful revenue from that.

Balu Balakrishnan:

So, outside of cellphones, we think we'll start seeing revenue in all other markets; industrial, consumer, and computer market, starting in 2016. We have number of designs going on in those areas, so we already talked about two designs that we have won; one in the ultrabook, the other one in the industrial market, and appliance, there are two major appliance companies who have qualified InnoSwitch but—they have a long design cycle but we expect significant revenue contributions from non-cellphone markets next year and of course the cellphone market itself is in the early stages. It'll continue to grow also.

Tore Svanberg:

Very helpful. Thank you very much.

Balu Balakrishnan:

You're welcome, Tore.

Operator:

Your next question comes from the line of Steve Smigie from Raymond James. Your line is now open.

Vince Celentano:

Thanks. This is Vince Celentano in for Steve. First I want to know if you can talk about the competitive environment in LED and specifically are you gaining share in North America and Europe, and have you been seeing any increased competition from the Chinese LED makers?

Balu Balakrishnan:

I think we have talked about this before. In the low end of the bulb market, we have seen a significant competition from the Chinese companies, Chinese IC vendors, and that's primarily in the applications for Third World countries where you don't need the efficiency, you don't need the power factor correction, and they don't need dimming. So, it's really the commoditized part of the bulb market where we have decided not to play because it's not attractive for us. The reason it's not attractive is that it doesn't appreciate the benefits of integration, such as fewer component count which means higher reliability, longer life cycle—life time, and also higher efficiency and power factor correction, isolation, and so on and so forth.

So we will play in the brand name bulb market, those bulbs that are sold in the US and Europe where you do need to meet these requirements and so we think those are attractive markets. In fact, we will be introducing a product specifically for that in the second half of this year and beyond that we are doing very well in the high margin, significantly higher margin markets like commercial lighting, industrial lighting, traffic lights, signage, and emergency lighting, and so on, which have the benefit of really using the benefits we bring from our integration, plus those markets are much more fragmented and spread geographically. So, it's a lot easier for us to address than a small Chinese company and they do care about reliability a lot. So, that's where we are focusing our efforts.

Vince Celentano:

Okay. Thanks a lot for that color and then going to the CT-Concept business, I mean last quarter you said that that's an area where you can see perhaps high ten (phon) digit growth in 2015. I was hoping if you can talk a little about 2016. Is this a business that can grow maybe 20%? How is that doing as far as gaining share?

Balu Balakrishnan:

Well, it's really hard to project that far. We have hard time forecasting even the next quarter, but at a high level I would say that the renewable part of that business is where we are seeing the most significant growth, specifically wind power and solar. There is a lot of capacity being installed in places like China, India, and US, even Europe is slowly coming back and this is all driven by grid parity and below grid prices for electricity generated by solar, and of course wind has always been below grid for quite some time now. So, there is definitely a growth area there. Traction is doing very well. So, the only area that is--we have had challenges in is in oil exploration which is a relatively small part of the business but that has been affected by the oil prices.

The other impact we've had is in currencies and the euro being strong reduces our European revenue by a small amount because we sell only the high-power products in Europe in euros, and the other small impact is the Russian currency which has basically taken the Russian revenue away.

But all of that is behind us. Going forward, we think that energy efficiency is going to drive this market. We have a roughly about 10% share of this market and the rest of the market is essentially captive but increasingly going to outsourcing the IGBT drivers to CT-Concept and CT-Concept which is now Power Integrations, is the only supplier—independent supplier of IGBT drivers right now.

Vince Celentano:

Okay, great. Thank you very much.

Balu Balakrishnan:

You're welcome.

Operator:

Your next question comes from Gus Richard from Northland. Your line is now open.

Gus Richard:

Yes, thanks for taking my question. When I look at your PC business, it looks like it's down by a whole third in the first half and it's hard for me to reconcile that with the end-market even now obviously the end-market is weak – was there just a tremendous amount of inventory coming into the year I would—I wouldn't expect at those levels a lot of inventory to be downstream from you.

Balu Balakrishnan:

Yes. The reason for that is we don't directly correlate with the OEM shipments. We ship to the power supply companies and so we seem to have—we are not only disconnected in terms of timing but the volatility of our business is much higher than the OEM shipments. So, if you look—if you go back a couple of years, you'll notice that our revenues have gone down 20% one quarter and come back up 20% the next quarter, and so on and so forth. So, it's very difficult correlate that with the end-market business.

The other thing unique of course is that we have our main exposure in that market—I mean our dominant exposure is PC standby, followed by monitors and then to a much smaller extent printers, and monitors have not done very well in terms of shipments either.

Gus Richard:

I see. Do you expect that that business to grow sequentially?

Balu Balakrishnan:

Well, we are assuming that it is not going to decline sequentially because it's declined so much, but we are being very cautious and we really don't want to assume that it's going to grow.

Gus Richard:

I understand, and then on the consumer side, you've mentioned that there was weakness in appliances and is that brown goods or is that air conditioners? How should we think about that going into the summer quarter?

Balu Balakrishnan:

It's all of it, both large appliances—I would say large appliances is probably the biggest one and then the AC, I mean air conditioning, and then the small appliances or what you call brown goods, and it's also geographically distributed. It's not just any one geography, it's across the world, and that's what makes us think it's a kind of a demand issue, worldwide demand issue. It could be because of the stock market decline in China which may be shying customers away from making major purchases, it could be the Greek effect in Europe.

It is really hard to figure out what is causing it but we have a very very good share and share in appliances doesn't change very quickly. So, it is purely a demand issue and it's very broad based to the extent we can make out.

Gus Richard:

Then on DoE-6, does that drive content to you guys in the external power supply market?

Balu Balakrishnan:

Yes it does because the DoE-6 is very very tight spec and a number of the existing products do not meet it, so they have to switch over. The interesting thing is, because it's so tight, the new designs are more expensive because you have to have higher efficiency, and so even though there are a number of new designs that have been done, the power supply guys and the OEMs are reluctant to switch over until they have to because they don't want to ship a more expensive product ahead of the deadline which is I think February of 2016.

So we are—the ramp up I was expecting in the second half, is not as much as I thought because people are waiting to, waiting for the deadline before they switch over because of the increase in cost.

Gus Richard:

Got it. Is that also perhaps part of the problem in consumer that your customers are burning off the old inventory before the power supplies going into consumer?

Balu Balakrishnan:

It is possible but I really don't have a good feeling for that because of that long chain we have.

Gus Richard:

I understand. Okay. That's it for me. Thanks so much.

Balu Balakrishnan:

Thanks Gus.

Operator:

Again if you have a question, star one on your telephone keypad. Your next question comes from the line of Christopher Longiaru from Sidoti & Company. Your line is now open.

Christopher Longiaru:

Hey guys, thanks for taking my questions.

Balu Balakrishnan:

You're welcome.

Christopher Longiaru:

So, just want to dive into the gross margin for the quarter and your expectations a little bit. The yen takes a little while to kind of filter through. Were there any impacts from the yen in the June quarter or is that more being seen in the September quarter?

Sandeep Nayyar:

It will be more in the September quarter and a little bit in the December quarter because of the inventory levels.

Christopher Longiaru:

Okay, and then just in terms of the mix, higher mix of industrials this quarter, about how much would you say that affect the gross margin positively in the June quarter?

Sandeep Nayyar:

Well, I mean if you look at it, we kind of have guided somewhere between 52.5 and 53 and we came in a little over the guided range, so I would attribute it most of it related to that.

Christopher Longiaru:

Okay.

Sandeep Nayyar:

In the following quarter the mix is swinging backward because the growth sequentially will come more from the communication.

Christopher Longiaru:

Got it, and then just in terms of the operating model now, is this kind of an operating expense structure that you're going to in to kind of keep level at this point or do you still expect an increase in R&D expense sometime in the second half of the year?

Sandeep Nayyar:

Well the operating expenses for the balance of the year we have said we would keep it—we said Q3 will be around 30.5, slight increase from Q2 and we expect Q4 to be flat with Q3.

Christopher Longiaru:

Okay and then just in terms of—I know that you have a great percentage of the cash is offshore. Any plans for that cash at this point repatriating any of it, anything along those lines?

Sandeep Nayyar:

We—bulk of our cash is actually in the US.

Christopher Longiaru:

That's all I have. Thank you, guys.

Balu Balakrishnan:

Thanks Chris.

Operator:

Your next question comes from the line of Evan Wang from Stifel. Your line is now open.

Evan Wang:

Yes, thank you for taking my question. I was wondering if you could add a little more color to your inventory plans for the rest of the year. I think you had mentioned that you expect the level to come down. Is that reflecting more cautious picture to end demand or how do we read into that?

Sandeep Nayyar:

So, if you look at our traditional—I mean, our model has been 110 plus or minus 15 days and you can see we have inched up to like in the 140s and so what we are going to try to do is looking at where the demand was and you've had a little bit of a shortfall in the first half, looking back and looking at what we are thinking as the second half, we are kind of modulating our production levels which is also impacting the margin a little bit and we want to get back and that's where we'll have a gradual decline and we want to get back to our model. So, that's why you see it taper down through the rest of the year.

Evan Wang:

Okay and my follow-up question is about your gross margin trend and I know this a little farther out at about 2016. You had mentioned that InnoSwitch which has just started to penetrate other end-markets in 2016. So is that—will that help to drive gross margin expansion? Can we view InnoSwitch and LinkSwitch-4 as tailwinds?

Sandeep Nayyar:

It's hard to right now predict 2016 because it'll depend on the volume, depend on the total mix. I think for modeling purposes, I have always felt that, you know, historically if you look at it, our margin has been somewhere in the 52.5, 53 on an average. So, that's where we are running at. So, right now I think that's my best estimate at this point of time.

Evan Wang:

Okay, great. Thank you very much.

Balu Balakrishnan:

Thanks Evan.

Operator:

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

Joe Shiffler:

Okay, thanks very much. Thanks everyone for listening. I know it's a busy afternoon. So, we appreciate everyone listening. There will be a replay of this call available on our website which is investors.power.com. Thanks again and good afternoon.

Operator:

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