

Power Integrations, Inc.

First Quarter 2015 Results Conference
Call

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CORPORATE PARTICIPANTS

Balu Balakrishnan – *President and Chief Executive Officer*

Sandeep Nayyar – *Vice President of Finance and Chief Financial
Officer*

Joe Shiffler – *Director of Investor Relations*

PRESENTATION

Operator

Good afternoon, my name is Melissa and I would like to welcome everyone to the Power Integrations' First Quarter 2015 Results call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. To ask a question during that time, simply press star, then 1 on your telephone keypad. Thank you. Joe Shiffler, you may begin your conference.

Joe Shiffler

Thank you. Good afternoon and thanks for joining us to discuss Power Integrations' financial results for the first quarter of 2015. With me on the call are Balu Balakrishnan, President and CEO of Power Integrations; and Sandeep Nayyar, our Chief Financial Officer.

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

Our discussion today, including the Q&A session, will include forward-looking statements reflecting our forecast of certain aspects of the Company's future business and financial results. Such statements are denoted by words like will, would, believe, should, expect, outlook, estimate, plan, goal, anticipate, project, potential, forecast, and similar expressions that look toward future events or performance. Forward-looking statements are based on current information that is dynamic and subject to abrupt changes. Our forward-looking statements are subject to risks and uncertainties, which may cause actual results to differ materially from those projected or implied in our statements. Such risks and uncertainties are discussed in today's press release and in part two of our most recent Form 10-K filed with the SEC on February 10, 2015.

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

Balu Balakrishnan

Thanks, Joe, and good afternoon. First quarter revenues declined 5% sequentially, to \$82.6 million, in-line with our guidance, but below the midpoint of the range, primarily reflecting continued softness in the desktop PC market. Revenues in the computing category, which is dominated by desktops, fell by nearly 20% sequentially, and are off 35% in the past two quarters as the supply chain adjusts to the slowdown in the PC sales.

Notwithstanding the softness in PCs, and a somewhat mixed demand environment overall, we expect solid sequential revenue growth in the second quarter and we believe the drivers are in-place to enable continued growth in the second half of the year.

Shipments increased nearly 10% in Q1 compared to Q4 in anticipation of stronger demand through the distribution channel in the June quarter. We also expect growth in key focus areas in Q2 such as our high-power business which is rebounding after a soft first quarter, and the mobile phone market, where rapid charging programs continue to ramp. We have resolved the supply constraints that affected sales of our new InnoSwitch products in the first quarter, even

as demand for the product accelerates on the strength of new design wins.

InnoSwitch is an ideal match for the demands of rapid charging, which poses significant engineering challenges for power supply designers, in terms of size, efficiency, and component count. These challenges give us an opportunity for differentiation in a market that had become increasingly commoditized in recent years.

These dynamics are driving a turnaround in our communications category, which declined nearly 15% last year. In the first quarter of this year, communications revenues were up more than 15% from a year ago, in spite of supply constraints, and we expect that growth rate to accelerate in the second quarter, as rapid charging continues to ramp.

While our initial rollout has focused on mobile device chargers, InnoSwitch has a broad addressable market comprising hundreds of millions of AC/DC power supplies annually. Many of these power supplies will be subject to the new mandatory federal efficiency standards for external power supplies scheduled to take effect in early 2016. The so-called DoE-6 standards will apply not only to mobile devices, but also home networking equipment, cordless phones, set-top boxes, LCD monitors, and the countless other products that use external chargers and adapters.

With InnoSwitch and our new LinkSwitch 4 product family, we have a broad range of products to address the DoE-6 opportunity. InnoSwitch is equally attractive for embedded power supplies and is showing strong design traction in the appliance market where a top-tier OEM has already qualified the product for use in a broad range of major appliance applications.

Appliances have been a success story for us thanks to tighter efficiency requirements, the increased use of electronic controls in both large and small appliances, and the reliability benefits of integration, an increasingly important factor in big-ticket items like brand name appliances. With the arrival of InnoSwitch, which not only acts to our competitive advantage, but also our dollar content, we believe we can sustain strong growth in the appliance market in 2015 and beyond.

We also expect the industrial market to be a significant contributor to our growth this year and beyond, led by our high-power IGBT driver products. As expected, high-power sales in Q1 were affected by softness in energy exploration markets and currency headwinds. However, we expect double-digit sequential growth in high-power in the second quarter, driven by strength in solar and wind energy applications.

Overall, our revenue outlook for the second quarter is for a sequential increase of 5% to 10%. While projecting revenues beyond the current quarter is always difficult, we believe the stage is set for a good second half. We expect continued momentum in the appliance and the high-power markets, while InnoSwitch is poised to become a material revenue contributor as the year progresses, particularly with rapid charging and the new DoE standards becoming significant demand drivers.

Now 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 Q1 financials and touch on the outlook before we open it up for Q&A. As usual 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.

First quarter revenues decreased 5% sequentially, to \$82.6 million. As Balu noted, the computer market was the biggest driver of the decline, falling nearly 20% sequentially, on weak desktop demand, and the consequent inventory adjustments in the supply chain.

Communications revenues were down mid-single digits on seasonal softness at a large network equipment customer. Industrial revenues were also down mid-single digits as expected on lower revenue from high-power products. Consumer revenues decreased slightly as growth in appliances was offset by seasonal softness in consumer electronics.

Revenue mix for the quarter was 38% consumer, 33% industrial, 21% communication, and 8% computer. Non-GAAP gross margin for the quarter was 53.1%, down from the prior quarter as expected, primarily resulting from application and product mix, most notably higher revenues from cell phone chargers and lower revenues from industrial.

Non-GAAP operating expenses for the quarter were well below our forecast, coming in at \$29.7 million, an increase of just \$600,000 from the prior quarter, despite the addition of Cambridge Semiconductor, which we acquired in early January.

Excluding the acquisition, non-GAAP expenses decreased sequentially in spite of seasonally higher FICA taxes and the comparative effect of the December shutdown. The decrease is due partly to the timing of certain expenses that were pushed into Q2, but also reflects expense controls implemented in response to the weaker demand environment.

Continuing down the income statement, other income for the first quarter was negative \$223,000, driven by unfavorable currency fluctuations. Including this item, which reduced earnings by \$0.01 per share, non-GAAP earnings were \$0.43 per diluted share. Cash flow from operations was \$17.7 million and we utilized \$3.3 million for capital expenditures. We utilized \$15.4 million for the CamSemi acquisition, as the net purchase price of \$22.1 million was netted against a short-term loan issued to CamSemi in December. Other uses of cash included \$3.5 million in dividend payments and just under \$1 million for share repurchases.

We ended the quarter with \$173 million in cash and short-term securities, down about \$2 million from the prior quarter. Internal inventories ticked up slightly, rising by \$1 million during the quarter, while channel inventories expanded to about 7.5 weeks ahead of stronger Q2 demand. Internal inventory should remain at roughly the same level on a day's basis through the June quarter and then trend down in the second half of the year. We have minimal obsolescence risk in our product portfolio and are content to adjust inventory levels gradually as we have done throughout our history.

Turning to the outlook for the second quarter, we expect revenues to be up 5% to 10% sequentially, led by the communication and the industrial categories, as well as a modest rebound in the PC market. We expect non-GAAP gross margin to be in the range of 52.5% to 53%, down slightly from the first quarter, driven by the continued ramp of new products and less favorable end-market mix. However, we expect gross margin to rise modestly in the September quarter as we begin to see the flow-through of lower cost wafers reflecting the more favorable dollar/yen exchange rate.

We expect non-GAAP OPEX to be between \$31.5 million and \$32 million in the second quarter. The sequential increase reflects annual merit increases, which were effective April 1, and

expenses associated with our worldwide sales conference, which also took place in April. I do anticipate lower expenses in the September quarter, as the impact of the sales conference rolls off, and FICA expenses begin to trend down. Lastly, I expect the non-GAAP tax rate for the second quarter and for the balance of the year to be approximately 7%.

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

Joe Shiffler

Thanks, Sandeep. We'll go ahead and open the call up for Q&A now. Operator, would you please give the instructions for the Q&A session?

QUESTIONS AND ANSWERS

Operator

At this time, I'd like to remind everyone in order to ask a question, press star, then the number 1 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 Steve Smigie with Raymond James. Your line is open.

Steven Smigie

Great, thanks a lot guys. So I just want to follow-up on a couple comments, the first one was you mentioned some strength into the back half of the year. You guys do typically have some seasonal strength into September and I know that's one quarter, but since you mentioned the back half, could September potentially be up double digits?

Balu Balakrishnan

It's a little too early to say what the third quarter will be. However, with the number of drivers helping us, we think it'll be a good growth quarter. Specifically, we expect to see growth in high power and also InnoSwitch-based revenues that should grow very nicely throughout the year.

Steven Smigie

Okay and then, just on the ramp of fast charge, you mentioned some capacity constraints there. Did those change what your initial assumptions would have been for fast charge revenue this year or was that kind of already factored in and so things are kind of going as you might have expected at this point?

Balu Balakrishnan

I don't think it'll affect the overall revenue for 2015 in rapid chargers. It did restrict our revenue a little bit in Q1, but we are already caught up, and we shipped whatever was necessary in April. So I don't think it'll have an impact and we expect the revenues to grow throughout this year.

Steven Smigie

Okay and Sandeep, you mentioned the benefits going to gross margin, I think on currency there and modestly into September. Does it kind of continue to incrementally improve modestly [from there]? Or are there enough issues going on with mix and other stuff that we shouldn't really be taking margin up here?

Sandeep Nayyar

I think basically the mix is there, so what I would do for modeling purposes is from the Q2 levels, I think the currency being favorable and the mix a little unfavorable. I think the benefit will be

about 50 basis points or so in the third quarter and kind of flatten out or a little bit here and there, from there.

Steven Smigie

Okay, great. All right, thanks a lot guys.

Operator

Your next question comes from Ross Seymore with Deutsche Bank. Your line is open.

Ross Seymore

Hi, guys. I know, Balu, you talked about some capacity constraints in the rapid charge size. We've heard other companies talk glowingly about their wins in the space. Can you give a little bit more color about the competitive landscape in the space? How you're differentiated and are you better positioned with kind of big flagship wins or smaller customers, but a multitude of them? Any sort of competitive color about how POWI is situated would be helpful.

Balu Balakrishnan

Sure. I think InnoSwitch is by far the best solution for rapid charging. We do have a couple of competitors in this space, but I have to say that we are doing extremely well compared to the competition. So far, we have six Tier 1 customers in production and two Tier 2 customers, and the feedback we've been getting has been very, very positive.

Ross Seymore

Then, moving beyond that side of the equation, I know, Balu or Sandeep, you just talked about the gross margin and what the currency's going to do. When you start a new product like InnoSwitch, we realize that the gross margins are lower and then they trend up over time. When does that start to become an actual tailwind to gross margin? Or even just the headwind dissipate?

Sandeep Nayyar

Well, one of the things that we said, new products are a challenge and typically what happens is our products go into different end-markets. Right now, what's happening is InnoSwitch is not only a new product, but it's also focused on the communications, and as you know, as we're going to expand this into other markets it will take a little time and that's when you'll start getting some tailwinds as it starts going into the other markets. We continue to do the cost reductions, which will start benefitting us as the year progresses. But, just the mix is still quite a bit of a headwind compared to the benefits we are getting from yen.

Ross Seymore

I guess my final question, on the computing side of things; we'd hoped that it'd only be a one quarter issue where you went down substantially like it had been the last couple times. This time, clearly the end-market is part of the equation, but when you look forward, why do you expect it only to be a mild increase when, if we look back historically any time you drop roughly 20% you have a pretty substantial snapback in the following quarter?

Balu Balakrishnan

The honest answer is we don't know. So we thought Q1 would be flat, maybe even slightly up or slightly down, but we were surprised that it was down as far as it went down, which is 20%; two quarters in a row it went down 20%. I would have never expected that. It is true in the past, we have had a very sharp snapback, but there were no indications at this time that is going to happen, but I can't say for sure beyond modeling, PCs to increase slightly in Q2.

Ross Seymore

There's no market share issues as far as that double-dip of beyond 20?

Balu Balakrishnan

That is correct. Our biggest exposure is to the desktop market through PC standby and it's not a share issue in PC standby. In fact, in other areas like the main power supply, we are actually gaining share. We're also gaining share in monitors, where we have won a number of new designs.

Ross Seymore

Great. Thank you very much.

Balu Balakrishnan

You're welcome, Ross.

Operator

Your next question comes from Tore Svanberg with Stifel. Your line is open.

Tore Svanberg

Yes, thank you. I was hoping you could comment first a little bit on sort of order linearity? You know, Power Integrations tends to be a little bit different from all of the other analog companies out there on timing of orders and stuff. So I was hoping you could talk about linearity both in Q1 and what you've seen so far this quarter?

Sandeep Nayyar

So, basically what we saw in the last quarter, as Balu mentioned, I mean we had a pretty strong shipment quarter, but not a sell through quarter. You know, we shipped 88 million, but we recognized only 82.5. We had a pretty strong January, in terms of booking, February because of the Chinese New Year dipped down, and then March was lower than January, and then April has continued to be like March. So it's hard to look at the turns and see what it'll be because there is so much inventory in the channel and considering we have shipped pretty much more than we recognized revenue, that is what is also helping us think through as we look forward into the Q2 guidance.

Tore Svanberg

Okay, very good, and the question on InnoSwitch and Balu you mentioned, obviously, this technology applies for other areas outside of cell phones. Are there any devices we should start thinking about right now as having, you know, an important contribution? Or will those sort of just be dwarfed by the mobile phone opportunities?

Balu Balakrishnan

Well, in the short-term, mobile phone would be the largest growth factor simply because it has a concentrated customer base, and the design cycles are shorter, but the InnoSwitch is applicable to all other markets. It's applicable to the PC market, it's applicable to the consumer market, both in terms of appliances and entertainment products, whether it's set-top boxes and so on. It's also applicable to the industrial market. It's just that they have longer design cycles and therefore, it takes a little bit of time before we start to see revenue growth in those areas.

The good news is the margins are higher, so that would help us in the long-term. But, just to clarify on the margins, we are making improvements, incremental improvements in cost of

InnoSwitch, and we'll have a more significant improvement sometime next year, related to next generation technology that we would use to reduce cost quite significantly. We are very confident that InnoSwitch will come to margins consistent with all other products we have.

Tore Svanberg

Sounds good. Just one last question, you sound a little bit more upbeat on high power for the second half of the year and I know there's a lot of sort of moving parts. But I also know that China is a big percentage of that business and that's an area where we've heard about some potential weakness, especially on the industrial side. So are there some new programs or new products ramping in the second half that gives you more confidence about that business?

Balu Balakrishnan

Yes. Specifically, in solar and wind energy applications. We are seeing significant capacity being installed this year and next year. So that's where we see the most significant growth. Where we have seen a little bit of a drag is in infrastructure-type projects like high-voltage DC transmission and so on, but that's a relatively small portion of the business. Our number one high power business is motor control, or what do you call—motor drives, I should say, and the number two is renewables and renewables is where we are seeing significant growth in the next few quarters.

Tore Svanberg

That's very helpful. Thank you very much.

Balu Balakrishnan

You're welcome, Tore.

Operator

Again, if you would like to ask a question, star, then the number 1 on your telephone keypad. Your next question comes from Gus Richard with Northland. Your line is open.

Gus Richard

Yes, thanks for taking the question and pronouncing my name right. Just a couple quick questions on the networking product, was that down in the quarter did you say?

Balu Balakrishnan

Yes

Gus Richard

Okay and do you expect that to recover or is that sort of in a state of decline, going forward?

Balu Balakrishnan

Well, it's—we don't know of any change in terms of shares. So it is seasonally weak in Q1 and it also has a lot of variability quarter-to-quarter. Our expectation is that in Q2, that will come back relative to Q1.

Gus Richard

Okay and then, in terms of your overall cell phone business, rapid charge plus everything else, do you expect to see double-digit growth in overall cell phones? Or is there going to be a little bit less than that because of older products rolling off?

Balu Balakrishnan

You mean—are you talking specifically about Q2 growth or general for the whole year?

Gus Richard

Yes. Yes, Q2, I'm sorry.

Balu Balakrishnan

Q2. Yes, it could very well be in double-digits.

Balu Balakrishnan

Just as an indicator, you can see cell phones now as a percentage of the total communications business this last quarter was nearly 60%, it was typically about 50%. So, it's growing very nicely with rapid charge and everything else.

Gus Richard

Okay, got it. Got it. That's very helpful and then, looking at—you haven't mentioned LED in this quarter. So I was just wondering what was going on with that market for you guys?

Balu Balakrishnan

The LED revenues declined slightly compared to Q4 and that's quite seasonal. I mean we've seen every first quarter for the last three years decline in LED revenue, and that was the same this quarter, I mean this Q1.

Gus Richard

Got it and then, on DoE-6 products and the design-ends, do expect that revenue to start to ramp in the back half of the year or is that a '16 type of phenomenon?

Balu Balakrishnan

It should start in the back half of the year because they have to get the designs done and plus get the production started, but we will see the full year impact only in 2016.

Gus Richard

Okay. So it'll aid in the second half of the year?

Balu Balakrishnan

Yes. It'll ramp continuously through the second half and obviously, it'll ramp up to the full volume by the end of the year.

Gus Richard

Okay, got it, and then, last one for me. I'm sorry for so many questions. Given the slow start to the year, it looks really challenging to get flat to—on your PC business, is that a realistic expectation? Or do you think that the snapbacks will be a little harder in the second half?

Balu Balakrishnan

Well, that's a good question. As I said, it's really hard to predict how PC market would do. But, the good news is it's not a share issue, we have a very significant share of the standby market, and we are growing share in a number of other areas like the main power supply and the LCD monitors. So those things bode well, but it is very hard to project exactly what it will do for the whole year.

Gus Richard

Okay. Thanks so much.

Balu Balakrishnan

You're welcome.

Operator

Your next question comes from Christopher Longiaru with Sidoti & Company. Your line is open.

Christopher Longiaru

Hey, guys, thanks for taking my question.

Balu Balakrishnan

You're welcome.

Christopher Longiaru

So, can you give us a little bit of color into how inventories kind of trended over the course of the quarter? How orders kind of trended and maybe, you know, how they've looked into April and how—and what kind of turns number do you need to hit your guide?

Sandeep Nayyar

So, you know, considering we shipped in last quarter, as I indicated, nearly 88 and we basically recognized only 82.5. So you can see the turns going to be a little difficult because you could have more revenue than shipments this quarter, right, even taking that into consideration, roughly we need high 40 turns like we had in Q1, to hit our number. As far as the order pattern, as I indicated earlier, January was where we had the peak in orders, February was down because of Chinese New Year, March came back, but not as high as January, and April has trended pretty close to March.

Balu Balakrishnan

Just to clarify Christopher, when you say turns, it's only based on what we ship because we don't know how much gets shipped through until the end of the quarter.

Christopher Longiaru

Right.

Balu Balakrishnan

In the first quarter, we shipped a lot more than we recognized in revenue, because the distributors bought quite a bit in March, in preparation for Q2, which bodes well for Q2. So we have to be careful when we talk about turns, we can only talk about turns in terms of shipments, but not in terms of revenue. Having said that, in terms of shipments, the turns we need if they were equal to revenue plus what we have coming from Q1 shipments, is roughly the same as Q1.

Christopher Longiaru

That's helpful, guys. I appreciate that and then, just in terms of, you know, you said that you expect a little bit of the September quarterly operating expenses to come down. What kind of—can you comment on any mask costs or anything along those lines that have happened recently and that you expect to happen over the course of the year that kind of alters your GAAP expenses? Or are there any big blips or is it pretty consistent?

Sandeep Nayyar

Well, basically in terms of GAAP expenses, I think, as you know we have added as a result of

the CamSemi acquisition. Now in Q1, we had the inventory write-up, which was about \$300,000, which I think goes away because the inventory's turned over. Apart from that, the rest of the amortization that was added should be pretty linear.

Christopher Longiaru

Okay. All right, that's all I have. Thank you guys.

Balu Balakrishnan

You're welcome.

Operator

Again, if you would like to ask a question, press star, then 1 on your telephone keypad. Your next question comes from Steve Smigie with Raymond James. Your line is open.

Steven Smigie

Great, thanks for the chance on the follow-up. I was just hoping you could comment a little bit on CT-Concept in terms of growth opportunity for this year? Could that grow something like 20% this year?

Sandeep Nayyar

So basically, as you know that the first quarter was much lower than the run rate. If you look at it like—from the—I mean it was a decline, nearly a double-digit that we only did close to about \$8 million. So I think 20% is maybe a little optimistic. I think would we do high single-digits, probably, yes.

Steven Smigie

Okay, cool, and then, similar on consumer. Can you talk a little bit about what kind of top-line growth percentage you think you could get this year?

Sandeep Nayyar

It's hard to predict the whole year, but I think we will continue to get good share gains in the appliance area, with content increasing and historically, last few years we've been doing mid to high single-digit growth there, too.

Balu Balakrishnan

We should also gain share in the TV market, with our TV main power supply product, and we expect to gain share in set-top boxes, also.

Steven Smigie

Okay, great. Thanks a lot guys.

Balu Balakrishnan

You're welcome.

Operator

There are no further questions in queue at this time. I turn the call back over to Joe Shiffler for any closing comments.

CONCLUSION**Joe Shiffler**

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

Operator

Ladies and gentlemen, this concludes today's conference call. You may now disconnect.