

IPG PHOTONICS CORP

Form 10-Q

November 06, 2009

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2009**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**Commission File Number 001-33155**

**IPG PHOTONICS CORPORATION**

**(Exact name of registrant as specified in its charter)**

**Delaware  
(State or other jurisdiction of  
incorporation or organization)**

**04-3444218  
(I.R.S. Employer  
Identification Number)**

**50 Old Webster Road, Oxford, Massachusetts  
(Address of principal executive offices)**

**01540  
(Zip code)**

**(508) 373-1100**

**(Registrant's telephone number, including area code)**

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES ☐ NO ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data file required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES ☐ NO ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated  
Filer ☐

Accelerated  
Filer ☐

Non-Accelerated Filer ☐  
(Do not check if a smaller reporting  
company)

Smaller Reporting  
Company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
YES ☐ NO ☐

As of November 02, 2009, there were 45,688,249 shares of the registrant's common stock issued and outstanding.



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**PART I FINANCIAL INFORMATION**  
**ITEM 1. UNAUDITED INTERIM FINANCIAL STATEMENTS**  
**IPG PHOTONICS CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**

	September 30, 2009	December 31, 2008
	(In thousands, except share and per share date)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 76,309	\$ 51,283
Accounts receivable, net	29,768	41,842
Inventories, net	59,155	72,555
Income taxes receivable	975	1,968
Prepaid expenses and other current assets	6,581	7,200
Deferred income taxes	11,275	6,175
Total current assets	184,063	181,023
DEFERRED INCOME TAXES	4,077	2,400
PROPERTY, PLANT AND EQUIPMENT, Net	114,957	114,492
OTHER ASSETS	15,842	15,303
TOTAL	\$ 318,939	\$ 313,218
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Revolving line-of-credit facilities	\$ 15,476	\$ 19,769
Current portion of long-term debt	1,333	1,333
Accounts payable	4,624	7,739
Accrued expenses and other liabilities	21,276	17,988
Deferred income taxes	201	1,690
Income taxes payable	3,341	507
Total current liabilities	46,251	49,026
DEFERRED INCOME TAXES AND OTHER LONG-TERM LIABILITIES	2,485	2,896
LONG-TERM DEBT	17,000	17,997
COMMITMENTS AND CONTINGENCIES		
IPG PHOTONICS CORPORATION STOCKHOLDERS EQUITY:		
Common stock, \$0.0001 par value, 175,000,000 shares authorized; 45,665,424 shares issued and outstanding at September 30, 2009; 44,965,960 shares issued and outstanding at December 31, 2008	5	4
Additional paid-in capital	291,673	283,217
Accumulated deficit	(51,546)	(53,843)

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Accumulated other comprehensive income	12,965	8,794
Total IPG Photonics Corporation stockholders' equity	253,097	238,172
NONCONTROLLING INTERESTS	106	5,127
Total equity	253,203	243,299
TOTAL	\$ 318,939	\$ 313,218

See notes to consolidated financial statements.

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**IPG PHOTONICS CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
	(In thousands, except per share data)			
NET SALES	\$ 45,808	\$ 62,012	\$ 131,601	\$ 170,882
COST OF SALES	29,085	32,590	87,245	90,113
GROSS PROFIT	16,723	29,422	44,356	80,769
OPERATING EXPENSES:				
Sales and marketing	3,788	3,735	10,857	10,585
Research and development	4,569	4,130	13,445	11,451
General and administrative	4,758	6,062	14,692	18,239
(Gain) loss on foreign exchange	(40)	(1,594)	975	(1,908)
Total operating expenses	13,075	12,333	39,969	38,367
OPERATING INCOME	3,648	17,089	4,387	42,402
OTHER (EXPENSE) INCOME, NET:				
Interest expense, net	(266)	(194)	(1,023)	(472)
Other (expense) income, net	(75)	(103)	(259)	433
Total other (expense) income	(341)	(297)	(1,282)	(39)
INCOME BEFORE PROVISION FOR INCOME TAXES	3,307	16,792	3,105	42,363
PROVISION FOR INCOME TAXES	(1,041)	(5,310)	(978)	(13,365)
NET INCOME	2,266	11,482	2,127	28,998
LESS: NET INCOME (LOSS) ATTRIBUTABLE TO NONCONTROLLING INTERESTS	11	589	(170)	1,404
NET INCOME ATTRIBUTABLE TO IPG PHOTONICS CORPORATION	\$ 2,255	\$ 10,893	\$ 2,297	\$ 27,594
NET INCOME ATTRIBUTABLE TO IPG PHOTONICS CORPORATION PER SHARE:				
Basic	\$ 0.05	\$ 0.24	\$ 0.05	\$ 0.62
Diluted	\$ 0.05	\$ 0.23	\$ 0.05	\$ 0.60
WEIGHTED-AVERAGE SHARES OUTSTANDING:				
Basic	45,573	44,685	45,368	44,380

Diluted	46,695	46,375	46,457	46,184
See notes to consolidated financial statements.				
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**IPG PHOTONICS CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Nine Months Ended September 30, 2009                      2008 (In thousands)</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 2,127	\$ 28,998
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	14,024	11,101
Deferred income taxes	(8,119)	(1,629)
Stock-based compensation	1,992	1,499
Loss (gain) on foreign currency transactions	1,077	(1,852)
Other	(29)	(566)
Provisions for inventory, warranty and bad debt	8,635	6,045
Changes in assets and liabilities that provided (used) cash:		
Accounts receivable	10,730	(6,237)
Inventories	2,844	(21,836)
Prepaid expenses and other current assets	(264)	3,530
Accounts payable	(1,481)	519
Accrued expenses and other liabilities	760	2,314
Income and other taxes payable	5,396	3,140
Net cash provided by operating activities	37,692	25,026
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of property, plant, equipment and intangible assets	(9,580)	(29,489)
Proceeds from sale of marketable securities		5,450
Other	58	191
Net cash used in investing activities	(9,522)	(23,848)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from line-of-credit facilities	17,393	21,049
Payments on line-of-credit facilities	(21,779)	(16,682)
Purchases of noncontrolling interests	(508)	(1,220)
Proceeds from long-term borrowings		20,044
Principal payments on long-term borrowings	(1,011)	(19,855)
Exercise of employee stock options and related tax benefit from exercise	2,121	2,359
Other	(61)	(75)
Net cash (used in) provided by financing activities	(3,845)	5,620
<b>EFFECT OF CHANGES IN EXCHANGE RATES ON CASH AND CASH EQUIVALENTS</b>	701	(431)
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	25,026	6,367
<b>CASH AND CASH EQUIVALENTS    Beginning of period</b>	51,283	37,972

CASH AND CASH EQUIVALENTS	End of period	\$ 76,309	\$ 44,339
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SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Cash paid for interest		\$ 1,163	\$ 1,317
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Income taxes paid		\$ 4,595	\$ 8,924
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Non-cash transactions:

Additions to property, plant and equipment included in accounts payable		\$ 50	\$ 981
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Inventory contributed to unconsolidated affiliate		\$ 238	\$
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Purchases of noncontrolling interests in exchange for Common Stock		\$ 3,027	\$
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Equipment contributed as investment in affiliates		\$	\$ 298
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See notes to consolidated financial statements.

**Nine Months Ended September 30,**  
**2009** **2008**  
**(In thousands, except share and per share data)**

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TOTAL IPG PHONTONICS CORPORATION STOCKHOLDERS EQUITY	253,097	228,419
NONCONTROLLING INTERESTS		
Balance, beginning of year	5,127	4,455
Net (loss) income attributable to noncontrolling interests	(170)	441
Purchase of noncontrolling interests	(3,535)	
Premium on purchase of noncontrolling interests	712	
Discount on purchase of noncontrolling interests	(2,028)	
Balance, end of period	106	4,896
TOTAL EQUITY	\$ 253,203	\$ 233,315

See notes to consolidated financial statements.

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**IPG PHOTONICS CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. BASIS OF PRESENTATION**

The accompanying unaudited interim consolidated financial statements have been prepared by IPG Photonics Corporation, or IPG, we, our, or the Company. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. The consolidated financial statements include our accounts and those of our subsidiaries. All intercompany balances have been eliminated in consolidation. These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto in our annual report on Form 10-K for the year ended December 31, 2008.

Effective January 1, 2009, we adopted provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 810, *Consolidation*, which were previously issued as Statement of Financial Accounting Standard (SFAS) 160 *Noncontrolling Interests in Consolidated Financial Statements* an amendment of ARB No. 51. The new provisions of FASB ASC 810 which were retrospectively applied:

- clarify that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements,
- require consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest,
- establish standards for accounting for changes in a parent's ownership interest in a subsidiary, and
- require expanded disclosures that clearly identify and distinguish between interests of the parent's owners and the interests of the noncontrolling owners of a subsidiary.

The calculation of earnings per share continues to be based on income amounts attributable to the parent. The changes in presentation prescribed by the new provisions of FASB ASC 810 are incorporated in the accompanying Consolidated Balance Sheets, Consolidated Statements of Operations, Consolidated Statements of Cash Flows and Consolidated Statements of Equity.

In the opinion of our management, the unaudited financial information for the interim periods presented reflects all adjustments necessary for a fair presentation of our financial position, results of operations and cash flows. The results reported in these consolidated financial statements are not necessarily indicative of results that may be expected for the entire year.

**2. RECENT ACCOUNTING PRONOUNCEMENTS**

In June 2009, the Financial Accounting Standards Board (FASB) issued its final Statement of Financial Accounting Standards (SFAS) No. 168 *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* a replacement of FASB Statement No. 162. SFAS No. 168 made the FASB Accounting Standards Codification (the Codification) the single source of U.S. GAAP used by nongovernmental entities in the preparation of financial statements, except for rules and interpretive releases of the SEC under authority of federal securities laws, which are sources of authoritative accounting guidance for SEC registrants. The Codification is meant to simplify user access to all authoritative accounting guidance by reorganizing U.S. GAAP pronouncements into roughly 90 accounting topics within a consistent structure; its purpose is not to create new accounting and reporting guidance. The Codification supersedes all existing non-SEC accounting and reporting standards and was effective for the company beginning July 1, 2009. Following SFAS No. 168, the Board will not issue new standards in the form of Statements, FASB Staff Positions, or Emerging Issues Task Force Abstracts; instead, it will issue Accounting Standards Updates. The FASB will not consider Accounting Standards Updates as authoritative in their own right; these updates will serve only to update the Codification, provide background information about the guidance, and provide the bases for conclusions on the change(s) in the Codification. In the description of Accounting Standards Updates that follows, references in *italics* relate to Codification Topics and Subtopics, and their descriptive titles, as appropriate.

In March 2008, the FASB issued standards requiring further disclosure on derivative instruments and hedging activities. The new standard applies to all derivative instruments and non-derivative instruments that are designated

and qualify as hedging instruments and related hedged items accounted . The new standard requires additional disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for, and (c) how derivative instruments and related hedged items affect an entity's financial position, results of operations, and cash flows. This standard was effective for the Company beginning January 1, 2009. The disclosures prescribed by this standard are included in Note 7.

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Effective June 30, 2009, we adopted a new FASB standard on disclosing related to financial instruments FASB ASC 825, *Financial Instruments*, which requires disclosures about fair value of financial instruments in interim reporting periods as well as in annual financial statements. The adoption of the new standard required the Company to provide additional disclosures, which are included in Note 8.

**3. INVENTORIES**

Inventories consist of the following (in thousands):

	<b>September 30, 2009</b>	<b>December 31, 2008</b>
Components and raw materials	\$ 19,458	\$ 27,482
Work-in-process	23,409	28,653
Finished goods	16,288	16,420
 Total	 \$ 59,155	 \$ 72,555

The Company recorded inventory provisions totaling \$5.6 million and \$3.3 million for the nine months ended September 30, 2009 and 2008, respectively. These provisions were recorded as a result of changes in market prices of certain components, the realizable value of those inventories through finished product sales and uncertainties related to the recoverability of the value of inventories due to technological changes and excess quantities. These provisions are reported as a reduction to components and raw materials and finished goods.

**4. FINANCING ARRANGEMENTS**

The Company's borrowings under existing financing arrangements consist of the following (in thousands):

	<b>September 30, 2009</b>	<b>December 31, 2008</b>
Revolving Line-of-Credit Facilities:		
Euro Credit and Overdraft Facilities	\$ 1,280	\$ 670
U.S. Line of Credit	14,196	19,099
 Total	 \$ 15,476	 \$ 19,769
 Term Debt:		
U.S. Long-Term Note	\$ 18,333	\$ 19,330
Less current portion	(1,333)	(1,333)
 Total long-term debt	 \$ 17,000	 \$ 17,997

**5. NET INCOME ATTRIBUTABLE TO IPG PHOTONICS CORPORATION PER SHARE**

The following table sets forth the computation of diluted net income attributable to IPG Photonics Corporation per share (in thousands, except per share data):

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	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
Net income attributable to IPG Photonics Corporation	\$ 2,255	\$ 10,893	\$ 2,297	\$ 27,594
Weighted average shares	45,573	44,685	45,368	44,380
Dilutive effect of common stock equivalents	1,122	1,689	1,089	1,804
Diluted weighted average common shares	46,695	46,375	46,457	46,184
Basic net income attributable to IPG Photonics Corporation per share	\$ 0.05	\$ 0.24	\$ 0.05	\$ 0.62
Diluted net income attributable to IPG Photonics Corporation per share	\$ 0.05	\$ 0.23	\$ 0.05	\$ 0.60

**6. COMPREHENSIVE INCOME**

Total comprehensive income and its components were as follows (in thousands):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
Net income	\$ 2,255	\$ 10,893	\$ 2,297	\$ 27,594
Other comprehensive income:				
Unrealized loss on secured note interest rate swap, net of tax	(83)	(132)	252	(199)
Unrealized loss on marketable securities, net of tax				(75)
Foreign currency translation adjustment	4,365	(9,313)	3,919	(2,939)
Comprehensive income	\$ 6,537	\$ 1,448	\$ 6,468	\$ 24,381

**7. DERIVATIVE FINANCIAL INSTRUMENTS**

Our primary market exposures are to interest rates and foreign exchange rates. We use certain derivative financial instruments to help manage these exposures. We execute these instruments with financial institutions we judge to be credit-worthy. We do not hold or issue derivative financial instruments for trading or speculative purposes.

We recognize all derivative financial instruments as either assets or liabilities at fair value in the consolidated balance sheet. We have used foreign currency forward contracts as cash flow hedges of forecasted intercompany settlements denominated in foreign currencies of major industrial countries. We have no outstanding foreign currency forward contracts. We have an interest rate swap that is classified as a cash flow hedge of our variable rate debt.

*Cash flow hedges* Our cash flow hedge is an interest rate swap under which we agree to pay fixed rates of interest. We have no derivatives that are not accounted for as a hedging instrument. The fair value amounts in the consolidated balance sheet at September 30, 2009 were (in thousands):

<b>Asset Derivatives</b>		<b>Liability Derivatives</b>	
<b>Balance Sheet Location</b>	<b>Fair Value</b>	<b>Balance Sheet Location</b>	<b>Fair Value</b>
		Deferred income taxes	



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Interest rate swap	Other Assets	\$	and other long-term liabilities	\$	1,273
Total		\$		\$	1,273

The derivative gains and losses in the consolidated statement of operations for the three months ended September 30, 2009, related to our interest rate swap contract were as follows (in thousands):

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	Pretax Gain	Pretax Loss on	Ineffective Portion
	Recognized in	Effective	of
	Other	Portion of	Gain on Derivative
	Comprehensive	Derivative	and
	Income on	Reclassified from	Amount Excluded
	Effective		from
			Effectiveness
Derivatives in Cash Flow	Portion of	Accumulated Other	Testing
Hedging Relationships	Derivative	Comprehensive	Recognized in
	Amount	Loss	Income
		Location	Amount
			Location
			Amount
Interest rate swap	\$ (133)	\$	\$

The derivative gains and losses in the consolidated statement of operations for the nine months ended September 30, 2009, related to our interest rate swap contract was as follows (in thousands):

	Pretax Gain	Pretax Loss on	Ineffective Portion
	Recognized in	Effective	of
	Other	Portion of	Gain on Derivative
	Comprehensive	Derivative	and
	Income on	Reclassified from	Amount Excluded
	Effective		from
			Effectiveness
Derivatives in Cash Flow	Portion of	Accumulated Other	Testing
Hedging Relationships	Derivative	Comprehensive	Recognized in
	Amount	Loss	Income
		Location	Amount
			Location
			Amount
Interest rate swap	\$ 405	\$	\$

The notional amount of the outstanding interest rate swap was \$18,333,000. We made no adjustments to the fair value of this derivative as a result of evaluating counterparty risk.

**8. FAIR VALUE MEASUREMENTS**

The following tables present our assets and liabilities that are measured at fair value on a recurring basis as of September 30, 2009 and December 31, 2008, and are categorized using the fair value hierarchy. The fair value hierarchy has three levels based on the reliability of the inputs used to determine fair value. Level 1 refers to fair values determined based on quoted prices in active markets for identical assets. Level 2 refers to fair values estimated using significant other observable inputs, and Level 3 includes fair values estimated using significant non-observable inputs.

	Fair Value Measurements at September 30, 2009			
	Total	Level 1	Level 2	Level 3
<b>Assets</b>				
Money market funds	\$ 2,209	\$ 2,209	\$	\$
Treasury bills	31,676	31,676		
Auction rate securities	1,309			1,309

<b>Total assets</b>	\$ 35,194	\$ 33,885	\$	\$ 1,309
<b>Liabilities</b>				
Interest rate swap	\$ 1,273	\$	\$ 1,273	\$
<b>Total liabilities</b>	\$ 1,273	\$	\$ 1,273	\$

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	<b>Fair Value Measurements at December 31, 2008</b>			
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets</b>				
Money market funds	\$ 22,560	\$ 22,560	\$	\$
Treasury bills	9,090	9,090		
Auction rate securities	1,309			1,309
<b>Total assets</b>	<b>\$ 32,959</b>	<b>\$ 31,650</b>	<b>\$</b>	<b>\$ 1,309</b>
<b>Liabilities</b>				
Interest rate swap	\$ 1,678	\$	\$ 1,678	\$
<b>Total liabilities</b>	<b>\$ 1,678</b>	<b>\$</b>	<b>\$ 1,678</b>	<b>\$</b>

The fair value of the auction rate securities was estimated utilizing a discounted cash flow analysis. The discounted cash flow analysis considered, among other items, the creditworthiness of the counterparty, the timing of expected future cash flows, and the expectation of the next time the security is expected to have a successful auction. The auction rate securities were also compared to other observable market data with similar characteristics to the securities held by the Company.

**9. INTANGIBLE ASSETS**

(In thousands)	<b>September 30, 2009</b>	<b>December 31, 2008</b>
Amortizable intangible assets		
Patents	\$ 3,650	\$ 3,650
Customer relationships	1,958	1,655
Other identifiable intangibles	136	544
	5,744	5,849
Accumulated amortization	(1,634)	(737)
	\$ 4,110	\$ 5,112

Amortization expense for the nine months ended September 30, 2009 was \$0.9 million.

The estimated future amortization expense for intangibles as of September 30, 2009 is as follows (in thousands):

<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>Thereafter</b>
\$407	\$1,208	\$1,208	\$929	\$318	\$ 40

**10. PRODUCT WARRANTIES**

The Company typically provides one to three-year parts and service warranties on lasers and amplifiers. Most of the sales offices provide support to customers in their respective geographic areas. Warranty reserves have been generally sufficient to cover product warranty repair and replacement costs. The following table summarizes product warranty activity recorded during the nine months ended September 30, 2009 and 2008 (in thousands):

	<b>2009</b>	<b>2008</b>
Beginning balance January 1	\$ 3,223	\$ 1,957
Additions for current year deliveries	1,959	2,484
Reductions for payments made	(1,659)	(1,423)
Impact of foreign currency fluctuation	64	(16)
Ending balance September 30	\$ 3,587	\$ 3,002

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### **11. COMMITMENTS AND CONTINGENCIES**

In November 2006, the Company was sued for patent infringement relating to certain products, including but not limited to fiber lasers and fiber amplifiers. The plaintiff has made a complaint for damages of over \$10 million, treble damages for alleged willful infringement and injunctive relief. The case is now in the discovery stages.

In February 2008, the Company was sued for patent infringement relating to two product lines used in medical laser applications. The plaintiff has filed a complaint for unspecified damages, treble damages for alleged willful infringement and injunctive relief. The patent asserted in the lawsuit expired in April 2007. The case was stayed until October 2009 in connection with a patent reexamination. The Company is seeking an extension of the stay.

The Company believes it has meritorious defenses and intends to vigorously contest the claims. No loss is deemed probable at September 30, 2009 and no amounts have been accrued in respect of these contingencies.

### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*You should read the following discussion in conjunction with our consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q. This discussion contains forward looking statements that are based on management's current expectations, estimates and projections about our business and operations. Our actual results may differ materially from those currently anticipated and expressed in such forward-looking statements. See Cautionary Statement Regarding Forward-Looking Statements.*

#### **Overview**

We develop and manufacture a broad line of high-performance fiber lasers, fiber amplifiers and diode lasers for diverse applications in numerous markets. Our diverse lines of low, mid and high-power lasers and amplifiers are used in materials processing, advanced, communications and medical applications. We sell our products globally to original equipment manufacturers, or OEMs, system integrators and end users. We market our products internationally primarily through our direct sales force and also through agreements with independent sales representatives and distributors.

We are vertically integrated such that we design and manufacture all key components used in our finished products, from semiconductor diodes to optical fiber preforms, finished fiber lasers and amplifiers. Since our formation in 1990, we have been focused on developing and manufacturing high-power fiber lasers and amplifiers.

#### **Factors and Trends That Affect Our Operations and Financial Results**

In reading our financial statements, you should be aware of the following factors and trends that our management believes are important in understanding our financial performance.

**Net sales.** Our net sales have historically fluctuated from quarter to quarter. The increase or decrease in sales from a prior quarter can be affected by the timing of orders received from customers, the shipment, installation and acceptance of products at our customers' facilities, the mix of OEM orders and one-time orders for products with large purchase prices, and seasonal factors such as the purchasing patterns and levels of activity throughout the year in the regions where we operate. Historically, our net sales have been higher in the second half of the year than in the first half of the year. Furthermore, net sales can be affected by the time taken to qualify our products for use in new applications in the end markets that we serve. The adoption of our products by a new customer or qualification in a new application can lead to an increase in net sales for a period, which may then slow until we further penetrate new markets or obtain new customers. Our net sales can also be affected from quarter to quarter by the general level of worldwide economic activity, including economic expansion or contraction, and expenditures on capital equipment. In general, increases in worldwide economic activity have a positive effect on our sales and decreases in economic activity have a negative effect on our sales.

**Gross margin.** Our total gross margin in any period can be affected by total net sales in any period, product mix, that is, the percentage of our revenue in that period that is attributable to higher or lower-power products, production volumes, changes to the sales prices of our products in response to the competitive environment and by other factors, some of which are not under our control. Our product mix affects our margins because the selling price per watt is higher for low-power and mid-power devices than for high-power devices. The overall cost of high-power lasers may be partially offset by improved absorption of fixed overhead costs associated with sales of larger volumes of higher-power products.

Due to the fact that we have high fixed costs, our costs are generally difficult or slow to adjust in response to changes in demand. In addition, our fixed costs increase as we expand our capacity. Gross margins generally decline if production volumes are lower as a result of a decrease in sales or inventory because the absorption of fixed manufacturing costs will be reduced. Gross margins generally improve when the opposite occurs. In addition, absorption of fixed costs can benefit gross margins due to an increase in production that is not sold and placed into inventory. If both sales and inventory decrease in the same period, the decline in gross margin may be magnified if we cannot reduce fixed costs or chose not to reduce fixed costs to match the decrease in the level of production. We also regularly review our inventory for items that are slow-moving, have been rendered obsolete or determined to be excess. If we experience a decline in sales that reduces absorption of our fixed costs, or if we have production issues or inventory write-downs, our gross margins will be negatively affected.

*Sales and marketing expense.* We expect to continue to expand our worldwide direct sales organization, build and expand applications centers, hire additional personnel involved in marketing in our existing and new geographic locations, increase the number of units used for demonstration purposes and otherwise increase expenditures on sales and marketing activities in order to support the growth in our net sales. As such, we expect that our sales and marketing expenses will increase in the aggregate.

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*Research and development expense.* We plan to continue to invest in research and development to improve our existing components and products and develop new components and products. We plan to increase the personnel involved in research and development and expect to increase other research and development expenses. As such, we expect that our research and development expenses will increase in the aggregate.

*General and administrative expense.* We expect our general and administrative expenses to increase moderately as we continue to invest in systems and resources to support our worldwide operations. Legal expenses vary from quarter to quarter based upon the stage of litigation, including patent re-examinations and termination of litigation stays but could increase in response to any future litigation or due to a change in status of current intellectual property matters. The timing and amount of legal expenses may vary substantially from quarter to quarter.

*Major customers.* We have historically depended on a few customers for a large percentage of our annual net sales. The composition of this group can change from year to year. Net sales derived from our five largest customers as a percentage of our annual net sales were 29% in 2006, 20% in 2007, 17% in 2008, and 12% for the nine months ended September 30, 2009. We seek to add new customers and to expand our relationships with existing customers. We anticipate that the composition of our net sales to our significant customers will continue to change. If any of our significant customers were to substantially reduce their purchases from us, our results would be adversely affected. Our sales have been affected recently by a substantial reduction in purchases of pulsed lasers from several customers, including one that was formerly our largest customer for several years.

### **Results of Operations for the three months ended September 30, 2009 compared to the three months ended September 30, 2008**

*Overview.* The worldwide economic downturn continued to negatively affect our results of operations for the three months ended September 30, 2009 as we experience continued weakness across many of our end markets, especially in materials processing. We continue to have limited longer term visibility to end market demand. Until end market demand becomes clearer, we will continue to focus on controlling costs and capital expenditures and reducing inventories in order to maximize cash flow. At the same time, we plan to continue to build on our technology by investing in new sales and application personnel and R&D for new products.

*Net sales.* Net sales decreased by \$16.2 million, or 26.1%, to \$45.8 million for the three months ended September 30, 2009 from \$62.0 million for the three months ended September 30, 2008. This decrease was attributable to lower sales of fiber lasers in materials processing applications, where net sales decreased by \$16.0 million or 31.4% and communications applications, where net sales decreased by \$2.3 million or 53.6%. These decreases were partially offset by the increases in advanced applications, where net sales increased by \$1.7 million, or 33.4%, and medical applications, where net sales increased by \$0.4 million or 24.0%. The decrease in materials processing sales resulted from lower sales of high and medium power lasers and pulsed lasers used in welding, marking, engraving and drilling applications. The decrease in communications applications sales resulted primarily from decreased sales of amplifiers, particularly in Russia. The increase in sales of advanced applications was due to higher sales of high power lasers used in government and defense research and pulsed and low power lasers used for sensing and optical pumping applications. The increase in medical is due to the increased demand from our established customer in the US and new OEM customers.

*Cost of sales and gross margin.* Cost of sales decreased by \$3.5 million, or 10.8%, to \$29.1 million for the three months ended September 30, 2009 from \$32.6 million for the three months ended September 30, 2008. Our gross margin decreased to 36.5% for the three months ended September 30, 2009 from 47.4% for the three months ended September 30, 2008. The decrease in gross margin was the result of less favorable absorption of our fixed manufacturing costs due to a decline in sales volume, less favorable product mix due to lower sales of medium power lasers and reduction of inventory as well as lower sales prices due to pricing pressure caused by the industry-wide reduction in demand. These cost of sales increases were partially offset by a reduction in manufacturing expenses in the period primarily related to reduced salaries and benefits expense and other manufacturing overhead. Expenses related to inventory reserves and other valuation adjustments decreased by \$0.4 million to \$1.3 million or 2.8% of sales for the three months ended September 30, 2009 as compared to \$1.7 million or 2.7% of sales for the three months ended September 30, 2008.



*Sales and marketing expense.* Sales and marketing expense increased by \$0.1 million, or 1.4%, to \$3.8 million for the three months ended September 30, 2009 from \$3.7 million for the three months ended September 30, 2008, primarily as a result of an increase in selling expenses related to depreciation of units used for demonstration purposes. As a percentage of sales, sales and marketing expense increased to 8.3% for the three months ended September 30, 2009 from 6.0% for the three months ended September 30, 2008. As we continue to expand our worldwide sales organization, we expect expenditures on sales and marketing to continue to increase in the aggregate although the near term increases may be more moderate.

*Research and development expense.* Research and development expense increased by \$0.5 million, or 10.6%, to \$4.6 million for the three months ended September 30, 2009 from \$4.1 million for the three months ended September 30, 2008. This increase was primarily due to an increase of \$0.2 million in material costs. Research and development activity continues to focus on enhancing the performance of our internally manufactured components, refining production processes to improve manufacturing yields, the development of new products operating at different wavelengths and higher output powers and new complimentary accessories used with our products. As a percentage of sales, research and development expense increased to 10.0% for the three months ended September 30, 2009 from 6.7% for the three months ended September 30, 2008.

*General and administrative expense.* General and administrative expense decreased by \$1.3 million, or 21.5%, to \$4.8 million for the three months ended September 30, 2009 from \$6.1 million for the three months ended September 30, 2008, primarily due to a

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decrease of \$0.9 million in bad debt, accounting, legal and contractor expenses. As a percentage of sales, general and administrative expense increased to 10.4% for the three months ended September 30, 2009 from 9.8% for the three months ended September 30, 2008. We expect that legal expenses will increase in future quarters in connection with defending two patent infringement actions against the Company.

*Effect of exchange rates on Sales, Gross Margin and Operating Expenses.* We estimate that if exchange rates had been the same as one year ago, our third quarter 2009 sales would have been \$0.2 million higher, gross margin would have been \$0.6 million higher and operating expenses in total would have been \$0.2 million higher.

*Gain on foreign exchange.* Gain on foreign exchange decreased by \$1.6 million to almost no gain or loss for the three months ended September 30, 2009 from a gain of \$1.6 million for the three months ended September 30, 2008 and was primarily attributable to the stabilization of the Russian Ruble and appreciation of Japanese Yen and Korean Won against the U.S. Dollar off-set by the depreciation of the U.S. Dollar against the Euro.

*Interest expense.* Interest expense, net was \$0.3 million for the three months ended September 30, 2009 compared to \$0.2 million for the three months ended September 30, 2008. The change in interest expense resulted from increased utilization of credit lines.

*Provision for income taxes.* Provision for income taxes was \$1.0 million for the three months ended September 30, 2009 compared to \$5.3 million for the three months ended September 30, 2008, representing an effective tax rate of 31.5% for both the three months ended September 30, 2009 and 31.6% for the three months ended September 30, 2008.

*Net income attributable to IPG Photonics Corporation.* Net income attributable to IPG Photonics Corporation decreased by \$8.6 million to \$2.3 million for the three months ended September 30, 2009 from \$10.9 million in income for the three months ended September 30, 2008. Net income attributable to IPG Photonics Corporation as a percentage of our net sales decreased by 12.7 percentage points to 4.9% for the three months ended September 30, 2009 from 17.6% for the three months ended September 30, 2008 due to the factors described above.

## **Results of Operations for the nine months ended September 30, 2009 compared to the nine months ended September 30, 2008**

*Overview.* The worldwide economic downturn continued to negatively affect our results of operations for the nine months ended September 30, 2009 as we experience continued weakness across many of our end markets, especially in materials processing. We continue to have limited longer term visibility to end market demand. Until end market demand becomes clearer, we will continue to focus on controlling costs and capital expenditures and reducing inventories in order to maximize cash flow. At the same time, we plan to continue to build on our technology by investing in new sales and application personnel and R&D for new products.

*Net sales.* Net sales decreased by \$39.3 million, or 23.0%, to \$131.6 million for the nine months ended September 30, 2009 from \$170.9 million for the nine months ended September 30, 2008. This decrease was attributable to lower sales of fiber lasers in materials processing applications, where net sales decreased by \$42.3 million or 29.8% and a decrease in communications applications, where net sales decreased by \$2.3 million or 23.6%. These decreases were partially offset by the increases sales of advanced applications, where net sales increased by \$3.7 million or 23.0% and in medical applications, where net sales increased by \$1.7 million, or 57.0%. The decrease in materials processing applications resulted from substantially decreased sales of pulsed lasers and medium-power lasers used in marking, engraving and drilling applications. The decrease in communications applications sales resulted primarily from decreased sales of amplifiers, particularly in Russia. The increase in sales of advanced applications was due to higher sales of high power lasers used in government and defense research and pulsed and low power lasers used for sensing and optical pumping applications. The increase in medical is due to the increased demand from our established customer in the US and new OEM customers.

*Cost of sales and gross margin.* Cost of sales decreased by \$2.9 million, or 3.2%, to \$87.2 million for the nine months ended September 30, 2009 from \$90.1 million for the nine months ended September 30, 2008. Our gross margin decreased to 33.7% for the nine months ended September 30, 2009 from 47.3% for the nine months ended September 30, 2008. The decrease in gross margin was the result of less favorable absorption of our fixed manufacturing costs due to a decline in sales volume, less favorable product mix due to lower sales of medium power lasers, a reduction in inventory, increases in charges related to inventory write-downs and lower prices due to pricing

pressure caused by the industry-wide reduction in demand. These cost of sales increases were offset partially by a reduction in manufacturing expenses in the period, primarily, related to reduced salaries and benefits expense and other manufacturing supplies. Expenses related to inventory reserves and other valuation adjustments increased by \$2.3 million to \$5.6 million, or 4.3%, of sales for the nine months ended September 30, 2009 as compared to \$3.3 million, or 1.9%, of sales for the nine months ended September 30, 2008.

*Sales and marketing expense.* Sales and marketing expense increased by \$0.3 million, or 2.6%, to \$10.9 million for the nine months ended September 30, 2009 from \$10.6 million for the nine months ended September 30, 2008, primarily as a result of an increase in selling and depreciation expenses. As a percentage of sales, sales and marketing expense increased to 8.2% for the nine months ended September 30, 2009 from 6.2% for the nine months ended September 30, 2008. As we continue to expand our worldwide sales organization, we expect expenditures on sales and marketing to continue to increase in the aggregate although the near term increases may be more moderate.

*Research and development expense.* Research and development expense increased by \$1.9 million, or 17.4%, to \$13.4 million for the nine months ended September 30, 2009 from \$11.5 million for the nine months ended September 30, 2008. This increase was

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primarily due to an increase of \$1.2 million in material costs. Research and development activity continues to focus on enhancing the performance of our internally manufactured components, refining production processes to improve manufacturing yields, the development of new products operating at different wavelengths and higher output powers and new complimentary accessories used with our products. As a percentage of sales, research and development expense increased to 10.2% for the nine months ended September 30, 2009 from 6.7% for the nine months ended September 30, 2008.

*General and administrative expense.* General and administrative expense decreased by \$3.5 million, or 19.5%, to \$14.7 million for the nine months ended September 30, 2009 from \$18.2 million for the nine months ended September 30, 2008, primarily due to a decrease of \$1.6 million decrease in accounting and legal defense fees and a \$1.8 million decrease in personnel and contractor expenses. We expect that legal expenses will increase in future quarters in connection with defending two patent infringement actions against the Company. As a percentage of sales, general and administrative expense increased to 11.2% for the nine months ended September 30, 2009 from 10.7% for the nine months ended September 30, 2008.

*Effect of exchange rates on Sales, Gross Margin and Operating Expenses.* We estimate that if exchange rates had been the same as one year ago, sales for the nine months ended September 30, 2009 would have been \$4.2 million higher, gross margin would have been \$2.5 million higher and operating expenses in total would have been \$1.5 million higher.

*Loss (gain) on foreign exchange.* Loss (gain) on foreign exchange increased by \$2.9 million to a loss of \$1.0 million for the nine months ended September 30, 2009 from a gain of \$1.9 million for the nine months ended September 30, 2008 and was primarily attributable to the depreciation of the Russian Ruble and Euro against the U.S. Dollar.

*Interest expense.* Interest expense, net was \$1.0 million for the nine months ended September 30, 2009 compared to \$0.5 million for the nine months ended September 30, 2008. The change in interest expense resulted from higher interest expense due to increased utilization of credit lines.

*Provision for income taxes.* Provision for income taxes was \$1.0 million for the nine months ended September 30, 2009 compared to \$13.4 million for the nine months ended September 30, 2008, representing an effective tax rate of 31.5% for both the nine months ended September 30, 2009 and for the nine months ended September 30, 2008.

*Net income attributable to IPG Photonics Corporation.* Net income attributable to IPG Photonics Corporation decreased by \$25.3 million to \$2.3 million for the nine months ended September 30, 2009 from \$27.6 million for the nine months ended September 30, 2008. Net income attributable to IPG Photonics Corporation as a percentage of our net sales decreased by 14.4 percentage points to 1.7% for the nine months ended September 30, 2009 from 16.1% for the nine months ended September 30, 2008 due to the factors described above.

**Liquidity and Capital Resources**

Our principal sources of liquidity as of September 30, 2009 consisted of cash and cash equivalents of \$76.3 million, unused credit lines and overdraft facilities of \$47.6 million and working capital (excluding cash) of \$61.5 million. This compares to cash and cash equivalents of \$51.3 million, unused overdraft facilities of \$40.9 million and working capital (excluding cash) of \$80.7 million as of December 31, 2008. The increase in cash and cash equivalents of \$25.0 million from December 31, 2008 relates primarily to cash provided by operating activities during the nine months ended September 30, 2009 of \$37.7 million, partially offset by capital expenditures of \$9.6 million, net repayments of our credit lines of \$4.4 million and the acquisition of non-controlling interests totaling \$0.5 million.

We held approximately \$1.3 million in auction-rate securities (ARSs) at September 30, 2009, all of which is included in other long-term assets. Our investments in ARSs at September 30, 2009 consisted solely of taxable municipal debt securities which are classified as long-term available for sale securities due to continued auction failures.

Our long-term debt consists of an \$18.3 million secured variable-rate note which matures in July 2013. The note is secured by a mortgage on real estate and buildings in Massachusetts. We expect that the existing cash and marketable securities, our cash flows from operations and our existing lines of credit will be sufficient to meet our liquidity and capital needs for the foreseeable future. Our future long-term capital requirements will depend on many factors

including our rate of net sales growth, the timing and extent of spending to support development efforts, the expansion of our sales and marketing activities, the timing and introductions of new products, the need to ensure access to adequate manufacturing capacity and the continuing market acceptance of our products. We have made no arrangements to obtain additional financing, and there is no assurance that such additional financing, if required or desired, will be available in amounts or on terms acceptable to us, if at all.

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The following table details our line of credit facilities as of September 30, 2009:

<b>Description</b>	<b>Total Facility</b>	<b>Interest Rate</b>	<b>Maturity</b>	<b>Security</b>
U.S. Revolving Line of Credit	\$35 million	LIBOR plus 0.8% to 1.2%, depending on the Company's performance	July 2011	Unsecured
Euro Credit Facility (Germany) (1)	Euro 15.0 million (\$21.9 million)	Euribor + 1.0% or EONIA + 1.5%	September 2010	Unsecured, guaranteed by parent company
Euro Overdraft Facilities	Euro 3.2 million (\$4.6 million)	2.82%-6.95%	Between September 2009 and March 2010	Common pool of assets of German and Italian subsidiaries

(1) \$4.0 million of this credit facility is available to our Russian subsidiary and \$1.3 million is available to our Italian subsidiary

The Company is required to meet certain financial covenants associated with its U.S. revolving line of credit and long term debt facilities. These covenants, tested quarterly, include a debt service coverage ratio and a funded debt to earnings before interest, taxes, depreciation and amortization (EBITDA) ratio. The debt service coverage covenant requires that we maintain a trailing twelve month ratio of cash flow to debt service that is greater than 1.5:1. Debt service is defined as required principal and interest payments during the period. Cash flow is defined as EBITDA less unfunded capital expenditures. For trailing twelve month periods until September 2010, up to \$15.0 million of our capital expenditures are treated as being funded from the proceeds of our initial public offering. The funded debt to EBITDA covenant requires that the sum of all indebtedness for borrowed money on a consolidated basis be less than two times our trailing twelve months EBITDA. We were in compliance with all such financial covenants as of September 30, 2009.

The financial covenants in our loan documents may cause us to not take or to delay investments and actions that we might otherwise undertake because of limits on capital expenditures and amounts that we can borrow or lease. In the event that we do not comply with any one of these covenants, we would be in default under the loan agreement or loan agreements, which may result in acceleration of the debt, cross-defaults on other debt or a reduction in available liquidity, any of which could harm our results of operations and financial condition.

*Operating activities.* Net cash provided by operating activities in the nine months ended September 30, 2009 increased by \$12.7 million to \$37.7 million from \$25.0 million in the nine months ended September 30, 2008 and primarily resulted from:

A decrease in inventory of \$2.8 million in 2009 compared to an increase of inventory of \$21.8 million in 2008;

A decrease in accounts receivable of \$10.7 million in 2009 compared to an increase of \$6.2 million in 2008; partially offset by

A decrease in cash provided by net income after adding back non-cash charges of \$23.9 million in 2009 as compared to 2008.

Given our vertical integration, rigorous and time-consuming testing procedures for both internally manufactured and externally purchased components and the lead time required to manufacture components used in our finished product, the rate at which we turn inventory has historically been low when compared to our cost of sales. We do not expect this to change significantly in the future and believe that we will have to maintain a relatively high level of inventory compared to our cost of sales. As a result, we continue to expect to have a significant amount of working capital invested in inventory.

*Investing activities.* Net cash used in investing activities was \$9.5 million and \$23.8 million in the nine months ended September 30, 2009 and 2008, respectively. The cash used in investing activities in the first nine months of 2009 was related to capital expenditures on property, plant and equipment. The cash used in investing activities in the first nine months of 2008 was primarily related to capital expenditures on property, plant and equipment and intangible assets of \$29.5 million, partially offset by \$5.5 million of proceeds from sale of marketable securities. In 2009 and 2008, capital expenditures in the United States, Germany, and Russia related to facilities and equipment for diode wafer growth, burn-in test stations and packaging as well as new fiber assembly and component production facilities. We expect capital expenditures to be lower than \$15 million for the year ended December 31, 2009. The timing and extent of any capital expenditures in and between periods can have a significant effect on our cash flow. Many of the capital expenditure projects that we undertake have long lead times and are difficult to cancel or defer, with the result that it would be difficult to defer such committed capital expenditures to a later period.

*Financing activities.* Net cash used by financing activities was \$3.8 million in the nine months ended September 30, 2009 as compared to cash provided by financing activities of \$5.6 million in the nine months ended September 30, 2008. The cash used by financing activities in 2009 was primarily related to the net repayments of \$4.4 million from the use of our credit lines and by cash used to purchase non-controlling interests of \$0.5 million, partially offset by \$2.1 million of exercise of employee stock options and related tax benefits. The cash provided by financing activities in 2008 was primarily related to the net proceeds of \$4.4 million from the use of our credit lines.

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### **Cautionary Statement Regarding Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, and we intend that such forward-looking statements be subject to the safe harbors created thereby. For this purpose, any statements contained in this Quarterly Report on Form 10-Q except for historical information are forward-looking statements. Without limiting the generality of the foregoing, words such as *may*, *will*, *expect*, *believe*, *anticipate*, *intend*, *estimate*, or *continue* or the negative or other variations thereof or comparable terminology are intended to identify forward-looking statements. In addition, any statements that refer to projections of our future financial performance, trends in our businesses, or other characterizations of future events or circumstances are forward-looking statements.

The forward-looking statements included herein are based on current expectations of our management based on available information and involve a number of risks and uncertainties, all of which are difficult or impossible to accurately predict and many of which are beyond our control. As such, our actual results may differ significantly from those expressed in any forward-looking statements. Factors that may cause or contribute to such differences include, but are not limited to, those discussed in more detail in Item 1, *Business* and Item 1A, *Risk Factors* of Part I of our Annual Report on Form 10-K for the period ended December 31, 2008. Readers should carefully review these risks, as well as the additional risks described in other documents we file from time to time with the Securities and Exchange Commission. In light of the significant risks and uncertainties inherent in the forward-looking information included herein, the inclusion of such information should not be regarded as a representation by us or any other person that such results will be achieved, and readers are cautioned not to rely on such forward-looking information. We undertake no obligation to revise the forward-looking statements contained herein to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

### **Recent Accounting Pronouncements**

See Note 2 to the condensed consolidated financial statements in Part I, Item 1 for information related to recent accounting pronouncements.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to market risk in the ordinary course of business, which consists primarily of interest rate risk associated with our cash and cash equivalents and our debt and foreign exchange rate risk.

*Interest rate risk.* Our investments have limited exposure to market risk. To minimize this risk, we maintain a portfolio of cash, cash equivalents and short-term investments, consisting primarily of bank deposits, money market funds and short-term government funds. The interest rates are variable and fluctuate with current market conditions. Because of the short-term nature of these instruments, a sudden change in market interest rates would not be expected to have a material impact on our financial condition or results of operations.

Our exposure to market risk also relates to the increase or decrease in the amount of interest expense we must pay on our bank debt and borrowings on our bank credit facilities. The interest rates for our U.S. revolving line of credit and our Euro credit facility are variable. The rates on our Euro overdraft facilities in Germany and Italy and our Japanese Yen overdraft facility are fixed for twelve-month periods. The interest rate on our other bank debt is currently fixed through interest-rate swaps. Approximately 54% of our outstanding debt had a fixed rate of interest as of September 30, 2009. We do not believe that a 10% change in market interest rates would have a material impact on our financial position or results of operations.

*Exchange rates.* Due to our international operations, a significant portion of our net sales, cost of sales and operating expenses are denominated in currencies other than the U.S. dollar, principally the Euro, the Japanese Yen and the Russian Ruble. As a result, our international operations give rise to transactional market risk associated with exchange rate movements of the U.S. dollar, the Euro, the Japanese Yen and the Russian Ruble. Gains and losses on foreign exchange transactions had no significant impact on the financial results for the three months ended September 30, 2009 and totaled a \$1.6 million gain for the three months ended September 30, 2008. Gains and losses on foreign exchange transactions totaled a \$1.0 million loss for the nine months ended September 30, 2009 and a \$1.9 million gain for the nine months ended September 30, 2008. Management believes that the use of foreign currency financial instruments reduces the risks of certain foreign currency transactions; however, these instruments provide only limited protection. We will continue to analyze our exposure to currency exchange rate fluctuations and



may engage in additional financial hedging techniques in the future to attempt to minimize the effect of these potential fluctuations. Exchange rate fluctuations may adversely affect our financial results in the future. No foreign currency derivative instruments were outstanding at September 30, 2009.

**ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

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Under the supervision of our chief executive officer and our chief financial officer, our management has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act)), as of the end of the period covered by this Quarterly Report on Form 10-Q (the Evaluation Date). Based upon that evaluation, our chief executive officer and our chief financial officer have concluded that, as of the Evaluation Date, our disclosure controls and procedures are effective.

### **Changes in Internal Controls**

There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) promulgated under the Exchange Act) that occurred during the last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

From time to time, we are party to various legal proceedings and other disputes incidental to our business. There have been no material developments in the second quarter of 2009 with respect to those proceedings previously reported in our Annual Report on Form 10-K for the year ended December 31, 2008, except as follows:

In July 2009, the United States Patent and Trademark Office (USPTO) confirmed the patentability of all of the claims in the IMRA America Inc., patent over the prior art cited in the reexamination, as well as of new claims added during the reexamination. The USPTO issued a reexamination certificate in October 2009. As result, the U.S. District Court for the Eastern District of Michigan lifted the stay on the litigation. A trial is scheduled for August 2010 and discovery has recommenced.

In June 2009, we submitted an additional reexamination request to the USPTO with respect to a patent asserted by CardioFocus Inc. against us. This request also been granted by the USPTO. The USPTO issued further office actions in July 2009 on the two patents not expressly asserted against us in the complaint, but that were referred to in the subsequent infringement allegations against us. All of the claims of one of the two patents were rejected, as were all but three claims of the other patent, the patentability of which was confirmed. The U.S. District Court for the District of Massachusetts has stayed the litigation until the earlier of October 2009 or the conclusion of the re-examination. The Court indicated that it will consider extending the stay for up to an additional year for good cause shown. We and the other defendants have requested that the Court extend the stay until the earlier of October 2010 or the conclusion of the re-examinations.

### **ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2008, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K and Quarterly Reports on Form 10-Q are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

***We are subject to litigation alleging that we are infringing third-party intellectual property rights. Intellectual property claims could result in costly litigation and harm our business.***

In recent years, there has been significant litigation involving intellectual property rights in many technology-based industries, including our own. We face risks and uncertainties in connection with such litigation, including the risk that patents issued to others may harm our ability to do business; that there could be existing patents of which we are unaware that could be pertinent to our business; and that it is not possible for us to know whether there are patent applications pending that our products might infringe upon, since patent applications often are not disclosed until a patent is issued or published. Moreover, the frequency with which new patents are granted and the diversity of jurisdictions in which they are granted make it impractical and expensive for us to monitor all patents that may be relevant to our business.

From time to time, we have been notified of allegations and claims that we may be infringing patents or intellectual property rights owned by third parties. In 2007, we settled two patent infringement lawsuits filed against us. We are presently defending two patent infringement lawsuits. In November 2006, IMRA America, Inc. filed an action against

us alleging that certain products we produce, including but not limited to our continuous wave and pulsed fiber lasers and fiber amplifiers, which account for a significant portion of our revenues, infringe one U.S. patent allegedly owned by IMRA America. IMRA America alleges willful infringement and seeks damages of at least \$10 million, treble damages and injunctive relief. IMRA America also alleges inducement of infringement and contributory infringement. We filed an answer in which we denied infringement and raised additional defenses that the patent is invalid and unenforceable. In addition, we filed declaratory judgment counterclaims based on these three defenses. This lawsuit

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concerns products made, used, sold or offered for sale in or imported into the United States and therefore the lawsuit affects products that account for a substantial portion of our revenues. This lawsuit does not affect revenues that are derived from products that are not made, used, sold or offered for sale in or imported into the United States. In June 2008, the U.S. Patent and Trademark Office ( USPTO ) ordered re-examination of the patent claims asserted by IMRA America against the Company based on several prior art references that we submitted in an *ex parte* re-examination request. In July 2009, the USPTO confirmed the patentability of all of the claims in the IMRA America patent over the prior art cited in the reexamination, as well as of new claims added during the reexamination. The USPTO issued a reexamination certificate in October 2009. As result, the U.S. District Court for the Eastern District of Michigan lifted the stay on the litigation. A trial is scheduled for August 2010 and discovery has recommenced. In August 2009, IPG submitted an additional reexamination request, which is being reviewed by the USPTO.

In February 2008, CardioFocus Inc. filed an action against us and other co-defendants alleging that our erbium and thulium fiber lasers infringe one patent allegedly owned by CardioFocus and seeks unspecified damages, treble damages and attorneys fees for alleged willful infringement. The plaintiff also alleges inducement of infringement. The patent claims generally relate to a system for transmitting laser energy via an optical fiber to a surgical site. The patent expired in April 2007. We filed an answer in which we denied infringement and raised additional defenses that the patent is invalid and unenforceable. In addition, we filed declaratory judgment counterclaims based on these three defenses. CardioFocus subsequently alleged that the Company infringes claims of two additional patents and we are investigating a response to such allegations. We and several of our co-defendants filed reexamination requests, which were granted by the USPTO. In two office actions in November 2008, the USPTO rejected all of the claims of the CardioFocus patents alleged to be infringed. In February 2009, CardioFocus responded to the USPTO office actions, and in June 2009, we submitted an additional reexamination request to the USPTO, which request has also been granted. The USPTO issued further office actions in July 2009 on the two patents not expressly asserted against the Company in the Complaint, but that were referred to in the subsequent infringement allegations against the Company. All of the claims of one of the two patents were rejected, as were all but three claims of the other patent, the patentability of which was confirmed. The U.S. District Court for the District of Massachusetts has stayed the litigation until the earlier of October 2009 or the conclusion of the re-examinations. The Court indicated that it will consider extending the stay for up to an additional year for good cause shown. We and the other defendants have requested that the Court extend the stay until the earlier of October 2010 or the conclusion of the re-examinations. Discovery has not yet commenced.

Several outcomes are possible from the ongoing re-examinations, including the cancellation or confirmation of one or more of the current claims of the patents. Furthermore, with regard to any unexpired patents in re-examination, the current claims can be amended, and new claims can be added, provided that such amendments and additions do not enlarge the overall scope of the claims. An adverse outcome in a USPTO re-examination could have an adverse impact on our defenses in our litigation with IMRA America and/or CardioFocus.

There can be no assurance that we will be able to amicably dispose of our pending litigation with IMRA America or CardioFocus, claims or other allegations made against us and claims that may be asserted in the future. The outcome of any litigation, including the pending litigation, is uncertain, as is the outcome of the re-examination of the CardioFocus patent. Even if we ultimately are successful on the merits of any such litigation or re-examination, legal and administrative proceedings related to intellectual property are typically expensive and time-consuming, generate negative publicity and divert financial and managerial resources. Some litigants may have greater financial resources than we have and may be able to sustain the costs of complex intellectual property litigation more easily than we can.

If we do not prevail in any intellectual property litigation brought against us, including the lawsuits brought by IMRA America and CardioFocus, it could affect our ability to sell our products and materially harm our business, financial condition and results of operations. These developments could adversely affect our ability to compete for customers and increase our revenues. Plaintiffs in intellectual property cases often seek, and sometimes obtain, injunctive relief. Intellectual property litigation commenced against us, including the lawsuits brought by IMRA America and CardioFocus that we are presently defending, could force us to take actions that could be harmful to our business, competitive position, results of operations and financial condition, including the following:

stop selling our products or using the technology that contains the allegedly infringing intellectual property;

pay actual monetary damages, royalties, lost profits or increased damages and the plaintiff's attorneys' fees, which individually or in the aggregate may be substantial;

attempt to obtain a license to use the relevant intellectual property, which may not be available on reasonable terms or at all; and

attempt to redesign the products that allegedly infringed upon intellectual property of others, which may be costly or impractical.

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In addition, intellectual property lawsuits can be brought by third parties against OEMs and end users that incorporate our products into their systems or processes. In some cases, we indemnify OEMs against third-party infringement claims relating to our products and we often make representations affirming, among other things, that our products do not infringe on the intellectual property rights of others. As a result, we may incur liabilities in connection with lawsuits against our customers. Any such lawsuits, whether or not they have merit, could be time-consuming to defend, damage our reputation or result in substantial and unanticipated costs.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

**OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

(a) Exhibits

**Exhibit**

<b>No.</b>	<b>Description</b>
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a)
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a)
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 1350

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized.

**IPG PHOTONICS CORPORATION**

Date: November 6, 2009

By: /s/ Valentin P. Gapontsev  
Valentin P. Gapontsev  
Chairman and Chief Executive Officer  
(Principal Executive Officer)

Date: November 6, 2009

By: /s/ Timothy P.V. Mammen  
Timothy P.V. Mammen  
Vice President and Chief Financial  
Officer  
(Principal Financial Officer)