

IPG PHOTONICS CORP  
Form 10-Q  
August 08, 2011

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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 June 30, 2011**

**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  Smaller Reporting Company

(Do not check if a 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 August 03, 2011, there were 47,473,967 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**

|                                                               | <b>June 30,<br/>2011</b>                                       | <b>December<br/>31,<br/>2010</b> |
|---------------------------------------------------------------|----------------------------------------------------------------|----------------------------------|
|                                                               | <b>(In thousands, except share and<br/>per<br/>share data)</b> |                                  |
| <b>ASSETS</b>                                                 |                                                                |                                  |
| <b>CURRENT ASSETS:</b>                                        |                                                                |                                  |
| Cash and cash equivalents                                     | \$ 188,196                                                     | \$ 147,860                       |
| Accounts receivable, net                                      | 73,284                                                         | 55,399                           |
| Inventories, net                                              | 109,273                                                        | 72,470                           |
| Income taxes receivable                                       | 4,419                                                          | 2,663                            |
| Prepaid expenses and other current assets                     | 17,179                                                         | 13,816                           |
| Deferred income taxes, net                                    | 7,449                                                          | 8,593                            |
| <br>                                                          |                                                                |                                  |
| Total current assets                                          | 399,800                                                        | 300,801                          |
| DEFERRED INCOME TAXES, NET                                    | 4,267                                                          | 4,489                            |
| INTANGIBLE ASSETS, NET                                        | 7,736                                                          | 7,131                            |
| PROPERTY, PLANT AND EQUIPMENT, NET                            | 141,902                                                        | 120,683                          |
| OTHER ASSETS                                                  | 7,676                                                          | 8,751                            |
| <br>                                                          |                                                                |                                  |
| <b>TOTAL</b>                                                  | <b>\$ 561,381</b>                                              | <b>\$ 441,855</b>                |
| <br><b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                |                                                                |                                  |
| <b>CURRENT LIABILITIES:</b>                                   |                                                                |                                  |
| Revolving line-of-credit facilities                           | \$ 7,205                                                       | \$ 6,841                         |
| Current portion of long-term debt                             | 1,586                                                          | 1,333                            |
| Accounts payable                                              | 14,884                                                         | 9,510                            |
| Accrued expenses and other liabilities                        | 50,732                                                         | 50,105                           |
| Deferred income taxes, net                                    | 8,866                                                          | 3,387                            |
| Income taxes payable                                          | 7,555                                                          | 11,594                           |
| <br>                                                          |                                                                |                                  |
| Total current liabilities                                     | 90,828                                                         | 82,770                           |
| DEFERRED INCOME TAXES, NET AND OTHER LONG-TERM<br>LIABILITIES | 4,661                                                          | 1,735                            |
| LONG-TERM DEBT, NET OF CURRENT PORTION                        | 16,758                                                         | 15,644                           |
| REDEEMABLE NONCONTROLLING INTERESTS                           | 46,730                                                         | 24,903                           |
| <br>                                                          |                                                                |                                  |
| Total liabilities                                             | 158,977                                                        | 125,052                          |
| <br>                                                          |                                                                |                                  |
| COMMITMENTS AND CONTINGENCIES (NOTE 13)                       |                                                                |                                  |
| IPG PHOTONICS CORPORATION STOCKHOLDERS EQUITY:                |                                                                |                                  |
|                                                               | 5                                                              | 5                                |

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Common stock, \$0.0001 par value, 175,000,000 shares authorized;  
47,437,688 shares issued and outstanding at June 30, 2011; 46,988,566  
shares issued and outstanding at December 31, 2010

|                                                      |            |            |
|------------------------------------------------------|------------|------------|
| Additional paid-in capital                           | 325,783    | 310,218    |
| Retained earnings                                    | 59,371     | 5,567      |
| Accumulated other comprehensive income               | 17,000     | 810        |
| Total IPG Photonics Corporation stockholders' equity | 402,159    | 316,600    |
| NONCONTROLLING INTERESTS                             | 245        | 203        |
| Total stockholders' equity                           | 402,404    | 316,803    |
| TOTAL                                                | \$ 561,381 | \$ 441,855 |

See notes to consolidated financial statements.

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**IPG PHOTONICS CORPORATION**  
**CONSOLIDATED STATEMENTS OF INCOME**

|                                                                 | Three Months Ended June               |           | Six Months Ended June |            |
|-----------------------------------------------------------------|---------------------------------------|-----------|-----------------------|------------|
|                                                                 | 30,                                   |           | 30,                   |            |
|                                                                 | 2011                                  | 2010      | 2011                  | 2010       |
|                                                                 | (in thousands, except per share data) |           |                       |            |
| NET SALES                                                       | \$ 121,936                            | \$ 67,258 | \$ 221,894            | \$ 118,462 |
| COST OF SALES                                                   | 55,230                                | 36,797    | 101,522               | 67,454     |
| GROSS PROFIT                                                    | 66,706                                | 30,461    | 120,372               | 51,008     |
| OPERATING EXPENSES:                                             |                                       |           |                       |            |
| Sales and marketing                                             | 5,847                                 | 4,932     | 10,795                | 9,270      |
| Research and development                                        | 6,610                                 | 4,729     | 12,341                | 8,887      |
| General and administrative                                      | 8,333                                 | 7,384     | 16,502                | 14,212     |
| (Gain) loss on foreign exchange                                 | (206)                                 | (2,295)   | 514                   | (2,403)    |
| Total operating expenses                                        | 20,584                                | 14,750    | 40,152                | 29,966     |
| OPERATING INCOME                                                | 46,122                                | 15,711    | 80,220                | 21,042     |
| OTHER EXPENSE, Net:                                             |                                       |           |                       |            |
| Interest expense, net                                           | (170)                                 | (191)     | (376)                 | (399)      |
| Other expense, net                                              | (618)                                 | (26)      | (610)                 | (92)       |
| Total other expense                                             | (788)                                 | (217)     | (986)                 | (491)      |
| INCOME BEFORE PROVISION FOR INCOME TAXES                        | 45,334                                | 15,494    | 79,234                | 20,551     |
| PROVISION FOR INCOME TAXES                                      | (13,827)                              | (5,149)   | (24,349)              | (6,782)    |
| NET INCOME                                                      | 31,507                                | 10,345    | 54,885                | 13,769     |
| LESS: NET INCOME ATTRIBUTABLE TO NONCONTROLLING INTERESTS       | 771                                   | 39        | 1,081                 | 66         |
| NET INCOME ATTRIBUTABLE TO IPG PHOTONICS CORPORATION            | \$ 30,736                             | \$ 10,306 | \$ 53,804             | \$ 13,703  |
| NET INCOME ATTRIBUTABLE TO IPG PHOTONICS CORPORATION PER SHARE: |                                       |           |                       |            |
| Basic                                                           | \$ 0.65                               | \$ 0.22   | \$ 1.14               | \$ 0.30    |
| Diluted                                                         | \$ 0.63                               | \$ 0.22   | \$ 1.11               | \$ 0.29    |
| WEIGHTED AVERAGE SHARES OUTSTANDING:                            |                                       |           |                       |            |
| Basic                                                           | 47,310                                | 46,220    | 47,205                | 46,159     |
| Diluted                                                         | 48,610                                | 47,333    | 48,650                | 47,262     |

See notes to consolidated financial statements.

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**IPG PHOTONICS CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

|                                                                                                                        | <b>Six Months Ended June 30,</b> |                |
|------------------------------------------------------------------------------------------------------------------------|----------------------------------|----------------|
|                                                                                                                        | <b>2011</b>                      | <b>2010</b>    |
|                                                                                                                        | <b>(In thousands)</b>            |                |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                                                           |                                  |                |
| Net income                                                                                                             | \$ 54,885                        | \$ 13,769      |
| Adjustments to reconcile net income to net cash provided by operating activities:                                      |                                  |                |
| Depreciation and amortization                                                                                          | 11,955                           | 10,514         |
| Deferred income taxes                                                                                                  | 6,624                            | (2,766)        |
| Stock-based compensation                                                                                               | 4,301                            | 1,563          |
| Gains (losses) on foreign currency transactions                                                                        | 551                              | (2,403)        |
| Other                                                                                                                  | 530                              | (51)           |
| Provisions for inventory, warranty & bad debt                                                                          | 7,056                            | 4,475          |
| Changes in assets and liabilities that provided (used) cash:                                                           |                                  |                |
| Accounts receivable                                                                                                    | (16,928)                         | (12,740)       |
| Inventories                                                                                                            | (35,193)                         | (9,515)        |
| Prepaid expenses and other current assets                                                                              | (4,555)                          | 391            |
| Accounts payable                                                                                                       | 4,888                            | 4,191          |
| Accrued expenses and other liabilities                                                                                 | (2,693)                          | 13,237         |
| Income and other taxes payable                                                                                         | (4,429)                          | 2,773          |
| Net cash provided by operating activities                                                                              | 26,992                           | 23,438         |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                                                           |                                  |                |
| Purchases of property, plant and equipment and intangible assets                                                       | (22,786)                         | (8,701)        |
| Acquisition of businesses, net of cash acquired                                                                        | (450)                            | (4,108)        |
| Other                                                                                                                  | 112                              | 117            |
| Net cash used in investing activities                                                                                  | (23,124)                         | (12,692)       |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                                                           |                                  |                |
| Proceeds from line-of-credit facilities                                                                                | 6,951                            | 5,543          |
| Payments on line-of-credit facilities                                                                                  | (6,817)                          | (5,033)        |
| Sale of redeemable noncontrolling interests                                                                            | 19,973                           |                |
| Principal payments on long-term borrowings                                                                             | (666)                            | (667)          |
| Exercise of employee stock options, issuances under employee stock purchase plan and related tax benefit from exercise | 10,247                           | 1,266          |
| Net cash provided by financing activities                                                                              | 29,688                           | 1,109          |
| <b>EFFECT OF CHANGES IN EXCHANGE RATES ON CASH AND CASH EQUIVALENTS</b>                                                | <b>6,780</b>                     | <b>(4,120)</b> |
| <b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>                                                                       | <b>40,336</b>                    | <b>7,735</b>   |

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|                                                                                                                      |                     |            |           |
|----------------------------------------------------------------------------------------------------------------------|---------------------|------------|-----------|
| CASH AND CASH EQUIVALENTS                                                                                            | Beginning of period | 147,860    | 82,920    |
| CASH AND CASH EQUIVALENTS                                                                                            | End of period       | \$ 188,196 | \$ 90,655 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:                                                                   |                     |            |           |
| Cash paid for interest                                                                                               |                     | \$ 514     | \$ 515    |
| Income taxes paid                                                                                                    |                     | \$ 14,905  | \$ 3,504  |
| Non-cash transactions:                                                                                               |                     |            |           |
| Demonstration units transferred from inventory to other assets                                                       |                     | \$ 1,291   | \$ 652    |
| Amounts related to acquisition of businesses included in accounts payable and accrued expenses and other liabilities |                     | \$ 882     | \$ 1,478  |
| Additions to property, plant and equipment included in accounts payable                                              |                     | \$ 545     | \$ 286    |
| Change in fair value of warrant                                                                                      |                     | \$ 654     | \$        |
| Property purchase financed with debt                                                                                 |                     | \$ 1,851   | \$        |

See notes to consolidated financial statements.

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**IPG PHOTONICS CORPORATION**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME**  
**(LOSS)**

|                                                                               | <b>Six Months Ended June 30,</b>                       |         |             |          |
|-------------------------------------------------------------------------------|--------------------------------------------------------|---------|-------------|----------|
|                                                                               | <b>2011</b>                                            |         | <b>2010</b> |          |
|                                                                               | <b>(In thousands, except share and per share data)</b> |         |             |          |
|                                                                               | Shares                                                 | Amount  | Shares      | Amount   |
| <b>COMMON STOCK</b>                                                           |                                                        |         |             |          |
| Balance, beginning of year                                                    | 46,988,566                                             | \$ 5    | 46,076,472  | \$ 5     |
| Exercise of stock options                                                     | 433,050                                                |         | 201,637     |          |
| Common stock issued under employee stock purchase plan                        | 16,072                                                 |         | 24,829      |          |
| Balance, end of period                                                        | 47,437,688                                             | 5       | 46,302,938  | 5        |
| <b>ADDITIONAL PAID-IN CAPITAL</b>                                             |                                                        |         |             |          |
| Balance, beginning of year                                                    |                                                        | 310,218 |             | 293,743  |
| Stock-based compensation                                                      |                                                        | 4,301   |             | 1,563    |
| Exercise of stock options and related tax benefit from exercise               |                                                        | 9,830   |             | 945      |
| Common stock issued under employee stock purchase plan                        |                                                        | 417     |             | 321      |
| Fair value of warrant transferred to additional paid-in capital upon exercise |                                                        | 674     |             |          |
| Sale of redeemable noncontrolling interests ( NCI )                           |                                                        | 10,138  |             |          |
| Increase redeemable NCI to initial redemption value                           |                                                        | (9,795) |             |          |
| Balance, end of period                                                        |                                                        | 325,783 |             | 296,572  |
| <b>RETAINED EARNINGS (ACCUMULATED DEFICIT)</b>                                |                                                        |         |             |          |
| Balance, beginning of year                                                    |                                                        | 5,567   |             | (48,424) |
| Net income attributable to IPG Photonics Corporation                          |                                                        | 53,804  |             | 13,703   |
| Balance, end of period                                                        |                                                        | 59,371  |             | (34,721) |
| <b>ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)</b>                          |                                                        |         |             |          |
| Balance, beginning of year                                                    |                                                        | 810     |             | 11,106   |
| Translation adjustments                                                       |                                                        | 17,335  |             | (20,664) |
| Unrealized gain (loss) on derivatives, net of tax                             |                                                        | 13      |             | (182)    |
| Attribution to NCI & redeemable NCI                                           |                                                        | (1,158) |             |          |

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|                                                                                     |                   |                   |
|-------------------------------------------------------------------------------------|-------------------|-------------------|
| Balance, end of period                                                              | 17,000            | (9,740)           |
| <b>TOTAL IPG PHOTONICS CORPORATION<br/>STOCKHOLDERS EQUITY</b>                      | <b>402,159</b>    | <b>252,116</b>    |
| <b>NONCONTROLLING INTERESTS</b>                                                     |                   |                   |
| Balance, beginning of year                                                          | 203               | 141               |
| Net income attributable to NCI                                                      | 31                | 66                |
| Other comprehensive income attributable to NCI                                      | 11                |                   |
| Balance, end of period                                                              | 245               | 207               |
| <b>TOTAL STOCKHOLDERS EQUITY</b>                                                    | <b>\$ 402,404</b> | <b>\$ 252,323</b> |
| <b>COMPREHENSIVE INCOME (LOSS)</b>                                                  |                   |                   |
| Net income                                                                          | \$ 54,885         | \$ 13,769         |
| Other comprehensive income (loss):                                                  |                   |                   |
| Translation adjustments                                                             | 17,335            | (20,664)          |
| Unrealized gain (loss) on derivatives, net of tax                                   | 13                | (182)             |
| Change in cumulative translation adjustment<br>attributable to NCI & redeemable NCI | (1,158)           |                   |
| Total comprehensive income (loss)                                                   | \$ 71,075         | \$ (7,077)        |

See notes to consolidated financial statements.

**Table of Contents****IPG PHOTONICS CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****1. BASIS OF PRESENTATION**

The accompanying unaudited 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 accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). 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, 2010.

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.

We have evaluated subsequent events through the time of filing this Quarterly Report on Form 10-Q with the SEC.

**2. RECENT ACCOUNTING PRONOUNCEMENTS**

In October 2009, the Financial Accounting Standards Board issued new accounting guidance for revenue recognition related to multiple element arrangements. This guidance established a selling price hierarchy, which allows the use of estimated selling prices to allocate arrangement consideration to deliverables in cases where neither vendor-specific objective evidence nor third-party evidence is available. The new guidance is effective for the Company prospectively for revenue arrangements entered into or materially modified beginning in the first quarter of fiscal 2011. The adoption of this accounting guidance did not have a material impact on the Company's consolidated financial statements and is not expected to have a material effect on the Company's consolidated financial statements in subsequent periods.

Revenue from orders with multiple deliverables is divided into separate units of accounting when certain criteria are met. These separate units generally consist of equipment and installation. The consideration for the arrangement is then allocated to the separate units of accounting based on their relative selling prices. The selling price of equipment is based on vendor specific objective evidence and the selling price of installation is based on third party evidence. Applicable revenue recognition criteria are then applied separately for each separate unit of accounting. Equipment revenue is generally recognized upon the transfer of ownership which is typically at the time of shipment. Installation revenue is recognized upon completion of the installation service which is typically completed within 30 to 90 days of delivery. Returns and customer credits are infrequent and are recorded as a reduction to revenue. Rights of return are generally not included in sales arrangements.

**3. INVENTORIES, NET**

Inventories consist of the following (in thousands):

|                              | <b>June 30,<br/>2011</b> | <b>December<br/>31,<br/>2010</b> |
|------------------------------|--------------------------|----------------------------------|
| Components and raw materials | \$ 38,963                | \$ 25,126                        |
| Work-in-process              | 36,929                   | 24,392                           |
| Finished goods               | 33,381                   | 22,952                           |
| Total                        | \$ 109,273               | \$ 72,470                        |

The Company recorded inventory provisions totaling \$2.2 million and \$1.4 million for the six months ended June 30, 2011 and 2010, respectively. These provisions 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.

**Table of Contents****4. ACCRUED EXPENSES AND OTHER LIABILITIES**

Accrued expenses and other liabilities consist of the following (in thousands):

|                                        | <b>June 30,<br/>2011</b> | <b>December<br/>31,<br/>2010</b> |
|----------------------------------------|--------------------------|----------------------------------|
| Accrued Compensation                   | \$ 18,549                | \$ 16,065                        |
| Customer Deposits and Deferred Revenue | 20,599                   | 20,685                           |
| Accrued Warranty                       | 6,187                    | 6,917                            |
| Other                                  | 5,397                    | 6,438                            |
| <br>                                   |                          |                                  |
| Total                                  | \$ 50,732                | \$ 50,105                        |

Accrued warranty reported in the accompanying consolidated financial statements as of June 30, 2011 consists of \$6.2 million in accrued expenses and other liabilities and \$2.6 million in deferred income taxes, net and other long-term liabilities.

**5. FINANCING ARRANGEMENTS**

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

|                                                    | <b>June 30,<br/>2011</b> | <b>December<br/>31,<br/>2010</b> |
|----------------------------------------------------|--------------------------|----------------------------------|
| Revolving Line-of-Credit Facilities:               |                          |                                  |
| Euro Overdraft Facilities                          | \$ 3,727                 | \$ 1,882                         |
| Foreign subsidiary drawings on U.S. Line of Credit | 3,478                    | 4,959                            |
| <br>                                               |                          |                                  |
| Total                                              | \$ 7,205                 | \$ 6,841                         |
| <br>                                               |                          |                                  |
| Term Debt:                                         |                          |                                  |
| U.S. Long-Term Note                                | \$ 16,000                | \$ 16,666                        |
| Other notes payable                                | 2,344                    | 311                              |
| Less: current portion                              | (1,586)                  | (1,333)                          |
| <br>                                               |                          |                                  |
| Total long-term debt                               | \$ 16,758                | \$ 15,644                        |

The U.S. line of credit is available to certain foreign subsidiaries and allows for borrowings in the local currencies of those subsidiaries.

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

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

|                                                      | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|------------------------------------------------------|----------------------------------------|-------------|--------------------------------------|-------------|
|                                                      | <b>2011</b>                            | <b>2010</b> | <b>2011</b>                          | <b>2010</b> |
| Net income attributable to IPG Photonics Corporation | \$ 30,736                              | \$ 10,306   | \$ 53,804                            | \$ 13,703   |
| Weighted average shares                              | 47,310                                 | 46,220      | 47,205                               | 46,159      |

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|                                                                        |         |         |         |         |
|------------------------------------------------------------------------|---------|---------|---------|---------|
| Dilutive effect of common stock equivalents                            | 1,300   | 1,113   | 1,445   | 1,103   |
| Diluted weighted average common shares                                 | 48,610  | 47,333  | 48,650  | 47,262  |
| Basic net income attributable to IPG Photonics Corporation per share   | \$ 0.65 | \$ 0.22 | \$ 1.14 | \$ 0.30 |
| Diluted net income attributable to IPG Photonics Corporation per share | \$ 0.63 | \$ 0.22 | \$ 1.11 | \$ 0.29 |

The computation of diluted weighted average common shares excludes options to purchase 89,000 and 373,000 shares for the three months and six months ended June 30, 2011 and 2010, respectively, because the effect would be anti-dilutive.

**Table of Contents****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 sheets. 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 interest rate swaps that are classified as a cash flow hedge of our variable rate debt. All derivatives are accounted for as a hedging instrument.

*Cash flow hedges* Our cash flow hedges are interest rate swaps under which we pay fixed rates of interest. The fair value amounts in the consolidated balance sheet were (in thousands):

|                       | Notional Amounts <sup>1</sup> |                   | Other Assets  |                   | Deferred Income Taxes and Other Long-Term Liabilities |                   |
|-----------------------|-------------------------------|-------------------|---------------|-------------------|-------------------------------------------------------|-------------------|
|                       | June 30, 2011                 | December 31, 2010 | June 30, 2011 | December 31, 2010 | June 30, 2011                                         | December 31, 2010 |
| Interest rate swap(s) | \$ 16,000                     | \$ 16,666         | \$            | \$                | \$ 1,135                                              | \$ 1,156          |
| Total                 | \$ 16,000                     | \$ 16,666         | \$            | \$                | \$ 1,135                                              | \$ 1,156          |

(1) Notional amounts represent the gross contract/notional amount of the derivatives outstanding.

The derivative gains (losses) in the consolidated statements of income related to our interest rate swap contracts were as follows (in thousands):

|                                                                                                  | Three Months Ended |               | Six Months Ended |               |
|--------------------------------------------------------------------------------------------------|--------------------|---------------|------------------|---------------|
|                                                                                                  | June 30, 2011      | June 30, 2010 | June 30, 2011    | June 30, 2010 |
| Effective portion recognized in other comprehensive (loss) gain, pretax:                         |                    |               |                  |               |
| Interest rate swap                                                                               | \$ 1               | \$ (5)        | \$ 340           | \$ 51         |
| Effective portion reclassified from other comprehensive (loss) gain to interest expense, pretax: |                    |               |                  |               |
| Interest rate swap                                                                               | \$ (164)           | \$ (173)      | \$ (319)         | \$ (346)      |
| Ineffective portion recognized in income:                                                        |                    |               |                  |               |
| Interest rate swap                                                                               | \$                 | \$            | \$               | \$            |

**8. REDEEMABLE NONCONTROLLING INTERESTS**

Redeemable noncontrolling interests reported in the accompanying consolidated financial statements as of June 30, 2011 consist of 22.5% of the Company's Russian subsidiary, NTO IRE-Polus ( NTO ).

|                                              | Redeemable Noncontrolling Interest |
|----------------------------------------------|------------------------------------|
| Balance at December 31, 2010                 | \$ 24,903                          |
| Initial interest in book value of subsidiary | 10,178                             |
| Increase to the initial redemption value     | 9,795                              |
| Net income attributable to redeemable NCI    | 1,049                              |

|                                                           |           |
|-----------------------------------------------------------|-----------|
| Other comprehensive income attributable to redeemable NCI | 805       |
| Balance at June 30, 2011                                  | \$ 46,730 |

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In December 2010, the Company entered into an investment agreement with an unrelated third party, The Russian Corporation for Nanotechnology ( Rusnano ) (the Investment Agreement ). Under the Investment Agreement, Rusnano acquired a 12.5% noncontrolling interest ( NCI ) in NTO and warrants to purchase up to an additional 12.5% of NTO in three tranches (two additional 5% interests for a purchase price of \$10 million each, and a 2.5% interest for \$5 million) if certain sales targets are achieved before December 2015. In June 2011, Rusnano exercised their warrants to purchase an additional 10% of NTO, as sales targets had been achieved related to the first two tranches. Rusnano invested \$25 million and \$20 million in NTO in December 2010 and June 2011, respectively.

**9. FAIR VALUE MEASUREMENTS**

Our financial instruments consist of accounts receivable, auction rate securities, accounts payable, drawings on revolving lines of credit, long-term debt and certain derivative instruments.

The valuation techniques used to measure fair value are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect internal market assumptions. These two types of inputs create the following fair value hierarchy: Level 1, defined as observable inputs such as quoted prices for identical instruments in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions.

The carrying amounts of accounts receivable, accounts payable and drawings on revolving lines of credit are considered reasonable estimates of their fair market value, due to the short maturity of these instruments or as a result of the competitive market interest rates, which have been negotiated.

The following table presents information about our assets and liabilities measured at fair value (in thousands):

|                                   | <b>Total</b>     | <b>Fair Value Measurements at<br/>June 30, 2011</b> |                 |                 |
|-----------------------------------|------------------|-----------------------------------------------------|-----------------|-----------------|
|                                   |                  | <b>Level 1</b>                                      | <b>Level 2</b>  | <b>Level 3</b>  |
| <b>Assets</b>                     |                  |                                                     |                 |                 |
| Money market funds                | \$ 18,380        | \$ 18,380                                           | \$              | \$              |
| Treasury bills                    | 44,984           | 44,984                                              |                 |                 |
| Auction rate securities           | 870              |                                                     |                 | 870             |
| <b>Total assets</b>               | <b>\$ 64,234</b> | <b>\$ 63,364</b>                                    | <b>\$</b>       | <b>\$ 870</b>   |
| <b>Liabilities</b>                |                  |                                                     |                 |                 |
| Contingent purchase consideration | \$ 1,047         | \$                                                  | \$              | \$ 1,047        |
| Warrant                           | 160              |                                                     |                 | 160             |
| Interest rate swaps               | 1,135            |                                                     | 1,135           |                 |
| <b>Total liabilities</b>          | <b>\$ 2,342</b>  | <b>\$</b>                                           | <b>\$ 1,135</b> | <b>\$ 1,207</b> |

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|                                   | <b>Fair Value Measurements at<br/>December 31, 2010</b> |                  |                 |                |
|-----------------------------------|---------------------------------------------------------|------------------|-----------------|----------------|
|                                   | <b>Total</b>                                            | <b>Level 1</b>   | <b>Level 2</b>  | <b>Level 3</b> |
| <b>Assets</b>                     |                                                         |                  |                 |                |
| Money market funds                | \$ 4,223                                                | \$ 4,223         | \$              | \$             |
| Treasury bills                    | 55,679                                                  | 55,679           |                 |                |
| Auction rate securities           | 921                                                     |                  |                 | 921            |
| <b>Total assets</b>               | <b>\$ 60,823</b>                                        | <b>\$ 59,902</b> | <b>\$</b>       | <b>\$ 921</b>  |
| <b>Liabilities</b>                |                                                         |                  |                 |                |
| Contingent purchase consideration | \$ 685                                                  | \$               | \$              | \$ 685         |
| Warrant                           | 180                                                     |                  |                 | 180            |
| Interest rate swaps               | 1,156                                                   |                  | 1,156           |                |
| <b>Total liabilities</b>          | <b>\$ 2,021</b>                                         | <b>\$</b>        | <b>\$ 1,156</b> | <b>\$ 865</b>  |

The fair value of the auction rate securities considered other indirectly observable market data with similar characteristics to the securities held by the Company.

The fair value of the accrued contingent purchase consideration incurred was determined using an income approach at the acquisition date and reporting date. That approach is based on significant inputs that are not observable in the market. Key assumptions include assessing the probability of meeting certain milestones required to earn the contingent consideration. As of June 30, 2011, the Company has accrued a liability of \$1.0 million for the estimated fair value of contingent considerations expected to be payable upon the acquired company reaching specific performance metrics over a three year period. As of June 30, 2011, the ranges of outcomes and key assumptions have not changed materially.

|                                          | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|------------------------------------------|----------------------------------------|-------------|--------------------------------------|-------------|
|                                          | <b>2011</b>                            | <b>2010</b> | <b>2011</b>                          | <b>2010</b> |
| <b>Auction Rate Securities</b>           |                                        |             |                                      |             |
| Balance, beginning of period             | \$ 870                                 | \$ 1,284    | \$ 921                               | \$ 1,284    |
| Change in fair value                     |                                        |             | (51)                                 |             |
| Balance, end of period                   | \$ 870                                 | \$ 1,284    | \$ 870                               | \$ 1,284    |
| <b>Contingent Purchase Consideration</b> |                                        |             |                                      |             |
| Balance, beginning of period             | \$ 1,023                               | \$ 289      | \$ 685                               | \$          |
| Period transactions                      |                                        | 381         | 282                                  | 670         |
| Change in fair value                     | 24                                     |             | 80                                   |             |
| Balance, end of period                   | \$ 1,047                               | \$ 670      | \$ 1,047                             | \$ 670      |

**Warrant**

|                              |        |    |        |    |
|------------------------------|--------|----|--------|----|
| Balance, beginning of period | \$ 180 | \$ | \$ 180 | \$ |
| Period transactions          | (674)  |    | (674)  |    |
| Change in fair value         | 654    |    | 654    |    |
| Balance, end of period       | \$ 160 | \$ | \$ 160 | \$ |

**Table of Contents****10. INTANGIBLES**

|                                | June 30, 2011         |                          |                     |                        | December 31, 2010     |                          |                     |                        |
|--------------------------------|-----------------------|--------------------------|---------------------|------------------------|-----------------------|--------------------------|---------------------|------------------------|
|                                | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Weighted-Average Lives | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Weighted-Average Lives |
| (In thousands)                 |                       |                          |                     |                        |                       |                          |                     |                        |
| Amortizable intangible assets  |                       |                          |                     |                        |                       |                          |                     |                        |
| Patents                        | \$ 4,664              | \$ (2,819)               | \$ 1,845            | 6 Years                | \$ 4,664              | \$ (2,361)               | \$ 2,303            | 6 Years                |
| Customer relationships         | 3,922                 | (1,364)                  | 2,558               | 5 Years                | 3,633                 | (998)                    | 2,635               | 5 Years                |
| Production know-how            | 2,676                 | (494)                    | 2,182               | 9 Years                | 2,518                 | (335)                    | 2,183               | 9 Years                |
| Technology license             | 1,272                 | (132)                    | 1,140               | 4 Years                |                       |                          |                     |                        |
| Other identifiable intangibles | 11                    |                          | 11                  |                        | 10                    |                          | 10                  |                        |
|                                | \$ 12,545             | \$ (4,809)               | \$ 7,736            |                        | \$ 10,825             | \$ (3,694)               | \$ 7,131            |                        |

The Company completed an acquisition through its Italian subsidiary in the first quarter of 2011. Consideration included cash payments aggregating \$0.9 million and contingent consideration with an aggregate fair value of \$0.3 million. Net assets acquired primarily consisted of intangible assets related to design license rights aggregating \$1.2 million.

The Company completed two acquisitions in 2010, one in the U.S. in the first quarter and one in Germany in the second quarter. Consideration paid included cash payments aggregating \$4.5 million and contingent consideration and seller provided financing with an aggregate fair value of \$1.0 million. Net assets acquired primarily consisted of intangible assets (patents, customer relationships, and production know-how with weighted-average estimated useful lives of 10 years, 5 years and 8 years, respectively) aggregating \$5.2 million.

Amortization expense for the three months and six months ended June 30, 2011 was \$511,000 and \$1.1 million, respectively. The estimated future amortization expense for intangibles as of June 30, 2011 for the remainder of 2011 and subsequent years is as follows (in thousands):

| 2011     | 2012     | 2013     | 2014     | 2015   | Thereafter | Total    |
|----------|----------|----------|----------|--------|------------|----------|
| \$ 1,179 | \$ 2,076 | \$ 1,464 | \$ 1,279 | \$ 530 | \$ 1,208   | \$ 7,736 |

**11. PRODUCT WARRANTIES**

The Company typically provides one to three-year parts and service warranties on lasers and amplifiers. Most of the Company's sales offices provide support to customers in their respective geographic areas. Warranty reserves have generally been sufficient to cover product warranty repair and replacement costs. The following table summarizes product warranty activity recorded during the six months ended June 30, 2011 and 2010 (in thousands).

|                                      | 2011     | 2010     |
|--------------------------------------|----------|----------|
| Balance at January 1                 | \$ 6,917 | \$ 3,886 |
| Provision for warranty accrual       | 3,293    | 2,384    |
| Warranty claims and other reductions | (1,923)  | (1,490)  |
| Foreign currency translation         | 508      | (354)    |

|                    |          |          |
|--------------------|----------|----------|
| Balance at June 30 | \$ 8,795 | \$ 4,426 |
|--------------------|----------|----------|

Accrued warranty reported in the accompanying consolidated financial statements as of June 30, 2011 consists of \$6.2 million in accrued expenses and other liabilities and \$2.6 million in deferred income taxes, net and other long-term liabilities.

## 12. INCOME TAXES

A reconciliation of the total amounts of unrecognized tax benefits is as follows (in thousands):

|                                                |             |
|------------------------------------------------|-------------|
|                                                | <b>2011</b> |
| Beginning balance January 1                    | \$ 2,951    |
| Gross decreases tax positions in prior periods |             |
| Gross increases tax positions in prior periods | 473         |
| Ending balance June 30                         | \$ 3,424    |

Substantially all of the liability for uncertain tax benefits related to various federal, state and foreign income tax matters, would benefit the Company's effective tax rate, if recognized.

**Table of Contents****13. COMMITMENTS AND CONTINGENCIES**

In November 2006, the Company was sued for patent infringement relating to certain U.S. products, including but not limited to fiber lasers and fiber amplifiers. The plaintiff filed a complaint for damages of over \$10 million, treble damages for alleged willful infringement and injunctive relief. The trial date is scheduled for September 2011. The Company believes it has meritorious defenses and is vigorously contesting the claims. No loss is deemed probable at June 30, 2011 and no amounts have been accrued in respect of this contingency.

**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 most of our 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 of 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 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.

A high proportion of our costs is fixed so they 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 greater if we cannot reduce fixed costs or choose not to reduce fixed costs to

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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.

*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 and associated level of legal activity.

*Major customers.* While 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 net sales were 18% for the six months ended June 30, 2011, 19% during 2010, 12% in 2009 and 17% in 2008. We seek to add new customers and to expand our relationships with existing customers. We anticipate that the composition of 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.

### **Results of Operations for the Three Months Ended June 30, 2011 Compared to the Three Months Ended June 30, 2010**

*Net sales.* Net sales increased by \$54.6 million, or 81.3%, to \$121.9 million for the three months ended June 30, 2011 from \$67.3 million for the three months ended June 30, 2010 (in thousands).

|                       | Three Months Ended June 30, |               | 2010             |               | Change           |              |
|-----------------------|-----------------------------|---------------|------------------|---------------|------------------|--------------|
|                       | 2011                        | % of Total    |                  | % of Total    |                  |              |
| Materials processing  | \$ 107,900                  | 88.5%         | \$ 57,265        | 85.1%         | \$ 50,635        | 88.4%        |
| Advanced applications | 6,253                       | 5.1%          | 5,382            | 8.0%          | 871              | 16.2%        |
| Communications        | 5,866                       | 4.8%          | 2,133            | 3.2%          | 3,733            | 175.0%       |
| Medical               | 1,917                       | 1.6%          | 2,478            | 3.7%          | (561)            | -22.6%       |
| <b>Total</b>          | <b>\$ 121,936</b>           | <b>100.0%</b> | <b>\$ 67,258</b> | <b>100.0%</b> | <b>\$ 54,678</b> | <b>81.3%</b> |

Sales for materials processing applications increased due to substantially increased sales of high power lasers used in cutting and welding applications and pulsed lasers used in marking and engraving applications both due to the continued economic recovery and, in the high power product line, due to increased acceptance of fiber laser technology. An increasing number of OEM customers have developed cutting systems that use our high power lasers and sales of these systems are gaining sales from gas laser systems. In addition, new welding processes using fiber lasers have been developed, increasing sales of lasers for this application which are replacing traditional laser and non-laser welding technologies. Sales for communications applications increased due to increased sales of broad-band systems in Russia. The increase in sales of advanced applications was due to increased sales for optical pumping and research and development applications and higher sales of high-power lasers used in government applications. Sales for medical applications decreased due to decreased demand from our established customer in the United States,

partially offset by increased sales to a newer European OEM medical customer.

*Cost of sales and gross margin.* Cost of sales increased by \$18.4 million, or 50.1%, to \$55.2 million for the three months ended June 30, 2011 from \$36.8 million for the three months ended June 30, 2010. Our gross margin increased to 54.7% for the three

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months ended June 30, 2011 from 45.3% for the three months ended June 30, 2010. Gross margin increased due to an improvement in manufacturing efficiency because the increase in manufacturing expenses was less than the increase in net sales. Absorption of our fixed manufacturing costs was also more favorable due to an increase in production volume, part of which was sold and part of which was placed in inventory. In addition, cost of sales benefited from a reduction in the cost per watt of our diodes and a decrease in the cost of internally manufactured optical components and accessories. Expenses related to inventory reserves and other valuation adjustments increased by \$0.1 million to \$0.9 million, or 0.8% of sales for the three months ended June 30, 2011, as compared to \$0.8 million, or 1.2% of sales for the three months ended June 30, 2010.

*Sales and marketing expense.* Sales and marketing expense increased by \$0.9 million, or 18.6%, to \$5.8 million for the three months ended June 30, 2011 from \$4.9 million for the three months ended June 30, 2010, primarily as a result of an increase in personnel costs due to an increase in headcount, stock-based compensation and bonus accruals, partially offset by a decrease in travel expenses. Bonus accruals increased due to an increase in net sales and headcount. Stock-based compensation increased in part due to increased fair value of stock options and restricted stock. As a percentage of sales, sales and marketing expense decreased to 4.8% for the three months ended June 30, 2011 from 7.3% for the three months ended June 30, 2010.

*Research and development expense.* Research and development expense increased \$1.9 million, or 39.8%, to \$6.6 million for the three months ended June 30, 2011, compared to \$4.7 million for the three months ended June 30, 2010, primarily as a result of an increase in personnel costs and material expenses. 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 integrated systems and new products operating at different wavelengths and higher output powers and new complementary accessories to be used with our products. As a percentage of sales, research and development expense decreased to 5.4% for the three months ended June 30, 2011 from 7.0% for the three months ended June 30, 2010.

*General and administrative expense.* General and administrative expense increased by \$0.9 million, or 12.9%, to \$8.3 million for the three months ended June 30, 2011 from \$7.4 million for the three months ended June 30, 2010, primarily due to an increase in personnel costs resulting from an increase in headcount, stock-based compensation and accruals for bonuses, partially offset by a decrease in legal fees related to a patent infringement action and lower bad debt expense. We will continue to incur significant legal expenses and expect legal expenses to increase in the third quarter as we prepare for the trial which is scheduled for September 2011.

Bonus compensation increased due to an improvement in our financial results. Stock-based compensation increased in part due to increased fair value of stock options and restricted stock. As a percentage of sales, general and administrative expense decreased to 6.8% for the three months ended June 30, 2011 from 11.0% for the three months ended June 30, 2010.

*Effect of exchange rates on net sales, gross profit and operating expenses.* We estimate that if exchange rates had been the same as one year ago, net sales for the three months ended June 30, 2011 would have been \$7.4 million lower, gross profit would have been \$3.6 million lower and total operating expenses would have been \$1.0 million lower.

*(Gain) loss on foreign exchange.* Foreign exchange gain decreased to \$0.2 million for the three months ended June 30, 2011 as compared to an exchange gain of \$2.3 million for the three months ended June 30, 2010. At the end of the second quarter our primary exposure to foreign exchange risk was due to our net dollar denominated assets held by subsidiaries with a Euro functional currency.

*Interest expense, net.* Interest expense, net remained consistent at \$0.2 million for the three months ended June 30, 2011 and for the three months ended June 30, 2010.

*Provision for income taxes.* Provision for income taxes was \$13.8 million for the three months ended June 30, 2011 compared to \$5.1 million for the three months ended June 30, 2010, representing an effective tax rate of 30.5% and 33.2% for the three months ended June 30, 2011 and 2010, respectively. The increase in the provision for income taxes was primarily the result of increased income before provision for income taxes. The decrease in effective rate was due primarily to the mix of income earned in various tax jurisdictions.

*Net income attributable to IPG Photonics Corporation.* Net income attributable to IPG Photonics Corporation increased by \$20.4 million to \$30.7 million for the three months ended June 30, 2011 compared to \$10.3 million for

the three months ended June 30, 2010. Net income attributable to IPG Photonics Corporation as a percentage of our net sales increased by 9.9 percentage

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points to 25.2% for the three months ended June 30, 2011 from 15.3% for the three months ended June 30, 2010 due to the factors described above.

**Results of Operations for the Six Months Ended June 30, 2011 Compared to the Six Months Ended June 30, 2010**

*Net sales.* Net sales increased by \$103.4 million, or 87.3%, to \$221.9 million for the six months ended June 30, 2011 from \$118.5 million for the six months ended June 30, 2010.

|                       | Six Months Ended June 30, |               | 2010              |               | Change            |              |
|-----------------------|---------------------------|---------------|-------------------|---------------|-------------------|--------------|
|                       | 2011                      | % of Total    | 2010              | % of Total    |                   |              |
| Materials processing  | \$ 194,297                | 87.6%         | \$ 100,006        | 84.4%         | \$ 94,291         | 94.3%        |
| Advanced applications | 14,485                    | 6.5%          | 10,065            | 8.5%          | 4,420             | 43.9%        |
| Communications        | 9,068                     | 4.1%          | 3,986             | 3.4%          | 5,082             | 127.5%       |
| Medical               | 4,044                     | 1.8%          | 4,405             | 3.7%          | (361)             | -8.2%        |
| <b>Total</b>          | <b>\$ 221,894</b>         | <b>100.0%</b> | <b>\$ 118,462</b> | <b>100.0%</b> | <b>\$ 103,432</b> | <b>87.3%</b> |

Sales for materials processing applications increased due to substantially increased sales of high power lasers used in cutting and welding applications and pulsed lasers used in marking and engraving applications both due to the continued economic recovery and increased acceptance of fiber laser technology. An increasing number of OEM customers have developed cutting systems that use our high power lasers and sales of these systems are gaining sales from gas laser systems. In addition, new welding processes using fiber lasers have been developed increasing sales of lasers for this application which are replacing traditional laser and non-laser welding technologies. Sales for communications applications increased due to increased sales of broad-band systems in Russia. The increase in sales of advanced applications was due to increased sales for optical pumping and research and development applications and higher sales of high-power lasers used in government applications. Sales for medical applications decreased due to decreased demand from our established customer in the United States, partially offset by increased sales to a newer European OEM medical customer.

*Cost of sales and gross margin.* Cost of sales increased by \$34.0 million, or 50.5%, to \$101.5 million for the six months ended June 30, 2011 from \$67.5 million for the six months ended June 30, 2010. Our gross margin increased to 54.2% for the six months ended June 30, 2011 from 43.1% for the six months ended June 30, 2010. Gross margin increased due to an improvement in manufacturing efficiency because the increase in manufacturing expenses was less than the increase in net sales. Absorption of our fixed manufacturing costs was also more favorable due to an increase in production volume, part of which was sold and part of which was placed in inventory. In addition, cost of sales benefited from a reduction in the cost per watt of our diodes and a decrease in the cost of internally manufactured optical components and accessories. Expenses related to inventory reserves and other valuation adjustments increased by \$0.8 million to \$2.2 million, or 10.0% of sales for the six months ended June 30, 2011 as compared to \$1.4 million, or 1.2%, of sales for the six months ended June 30, 2010.

*Sales and marketing expense.* Sales and marketing expense increased by \$1.5 million, or 16.5%, to \$10.8 million for the six months ended June 30, 2011 from \$9.3 million for the six months ended June 30, 2010, primarily as a result of an increase in personnel costs due to an increase in headcount, stock-based compensation and bonus accruals, partially offset by a decrease in depreciation expense related to products used for demonstration purposes. As a percentage of sales, sales and marketing expense decreased to 4.9% for the six months ended June 30, 2011 from 7.8% for the six months ended June 30, 2010.

*Research and development expense.* Research and development expense increased \$3.4 million, or 38.9%, to \$12.3 million for the six months ended June 30, 2011, compared to \$8.9 million for the six months ended June 30, 2010, primarily as a result of an increase in personnel costs and material expenses. 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 integrated systems and new products operating at different wavelengths and higher output powers and new complementary accessories to be used with our products. As a percentage of sales, research and development expense decreased to 5.6% for the six months ended June 30, 2011 from 7.5% for the six months ended June 30, 2010.

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*General and administrative expense.* General and administrative expense increased by \$2.3 million, or 16.1%, to \$16.5 million for the six months ended June 30, 2011 from \$14.2 million for the six months ended June 30, 2010, primarily due to an increase in personnel costs resulting from an increase in headcount, stock-based compensation and accruals for bonuses, partially offset by a decrease in legal fees related to a patent infringement action and lower bad debt expense. We will continue to incur significant legal expenses and expect legal expenses to increase in the third quarter as we prepare for the trial which is scheduled for September 2011. Stock-based compensation increased in part due to change in assumptions made during 2011 regarding how expense is recognized over the service period and increased fair value of stock options and restricted stock. As a percentage of sales, general and administrative expense decreased to 7.4% for the six months ended June 30, 2011 from 12.0% for the six months ended June 30, 2010.

*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 six months ended June 30, 2011 would have been \$8.5 million lower, gross margin would have been \$3.5 million lower and operating expenses in total would have been \$1.1 million lower. *(Gain) loss on foreign exchange.* We incurred a foreign exchange loss of \$0.5 million for the six months ended June 30, 2011 as compared to an exchange gain of \$2.4 million for the six months ended June 30, 2010 primarily due to the appreciation of the Euro against the U.S. Dollar.

*Interest expense.* Interest expense, net remained consistent at \$0.4 million for the six months ended June 30, 2011 and for the six months ended June 30, 2010.

*Provision for income taxes.* Provision for income taxes was \$24.3 million for the six months ended June 30, 2011 compared to \$6.8 million for the six months ended June 30, 2010, representing an effective tax rate of 30.7% and 33.0% for the six months ended June 30, 2011 and 2010, respectively. The decrease in effective rate was due primarily to the mix of income earned in various tax jurisdictions.

*Net income attributable to IPG Photonics Corporation.* Net income attributable to IPG Photonics Corporation increased by \$40.1 million to \$53.8 million for the six months ended June 30, 2011 from \$13.7 million for the six months ended June 30, 2010. Net income attributable to IPG Photonics Corporation as a percentage of our net sales increased by 12.6 percentage points to 24.2% for the six months ended June 30, 2011 from 11.6% for the six months ended June 30, 2010 due to the factors described above.

**Liquidity and Capital Resources**

Our principal sources of liquidity as of June 30, 2011 consisted of cash and cash equivalents of \$188.2 million, unused credit lines and overdraft facilities of \$52.2 million and working capital (excluding cash) of \$120.8 million. This compares to cash and cash equivalents of \$147.9 million, unused credit lines and overdraft facilities of \$51.5 million and working capital (excluding cash) of \$70.2 million as of December 31, 2010. The increase in cash and cash equivalents of \$40.3 million from December 31, 2010 relates primarily to cash provided by operating activities in the six months ended June 30, 2011 of \$27.0 million, a non-controlling equity investment of \$20.0 million in our Russian subsidiary by The Russian Corporation of Nanotechnologies ( Rusnano ) and exercises of employee stock options and related tax benefit, offset by capital expenditures of \$22.8 million. Cash provided by the Rusnano investment is used to fund the expansion of our business in Russia, including operating expenses, investments in working capital and capital expenditures. This funding is not available for use outside of Russia. Total cash investment provided by Rusnano is \$45.0 million.

Our long-term debt consists primarily of a \$16.0 million secured variable-rate note, of which \$1.3 million is the current portion. During the second quarter of 2010 we renegotiated the terms of this note, extending its maturity from August 2013 to June 2015, at which time the outstanding debt balance would be \$10.7 million. The variable interest rate was fixed by means of an interest rate swap through the original maturity date and that swap is still in place. In October 2010, we fixed the interest rate on this debt for the period from the original maturity date to the extended maturity date by means of a forward starting interest rate swap. The note is secured by a mortgage on real estate and buildings that we own in Massachusetts. In January 2011, we entered into a 10 year Euro 1.4 million (\$2.0 million) mortgage obligation to fund the purchase of a new building in Italy, of which \$0.3 million is the current portion. The interest on this mortgage obligation is fixed at 4.96% and it amortizes in full over the term of the obligation. The remaining long term debt consists of Euro 0.2 million (\$0.3 million) seller provided financing relating to the purchase of Cosytronic, KG in 2010.

We expect that our 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 level of sales, the impact of economic environment on our sales levels, the timing and extent of spending to support development efforts, the expansion of the global 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

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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.

The following table details our line-of-credit facilities as of June 30, 2011:

| <b>Description</b>                | <b>Available Principal</b>         | <b>Interest Rate</b>                                      | <b>Maturity</b>                     | <b>Security</b>                                          |
|-----------------------------------|------------------------------------|-----------------------------------------------------------|-------------------------------------|----------------------------------------------------------|
| U.S. Revolving Line of Credit (1) | Up to \$35 million                 | LIBOR plus 0.125% to 1.625%, depending on our performance | July 2015                           | Unsecured                                                |
| Euro Credit Facility (Germany)(2) | Euro 15.0 million (\$21.6 million) | Euribor + 0.85% or EONIA 1.2%                             | June 2012                           | Unsecured, guaranteed by parent company                  |
| Euro Overdraft Facilities         | Euro 2.6 million (\$3.7 million)   | 2.5%-6.5%                                                 | Between February 2012 and July 2012 | Common pool of assets of German and Italian subsidiaries |

(1) \$15.0 million of this credit facility is available to our foreign subsidiaries in their respective local currencies, including India, Italy, China, Japan and South Korea. Total drawings at June 30, 2011 were \$3.5 million with a weighted average interest rate of 1.3%.

(2) \$4.3 million of this credit facility is available to our Russian subsidiary and \$4.3 million is available to our Italian subsidiary. Total drawing at June 30, 2011 was \$3.1 million with an interest rate of 2.1%.

Our largest committed credit lines are with Bank of America and Deutsche Bank in the amounts of \$35.0 million and \$21.6 million, respectively, and neither of them is syndicated.

We are required to meet certain financial covenants associated with our 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 March 2011, up to \$15.0 million of our capital expenditures were treated as 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 shall be less than two times our trailing twelve months EBITDA. We were in compliance with all such financial covenants as of and for the six months ended June 30, 2011.

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.

In December 2010, we completed the sale of a 12.5% minority interest of our Russian subsidiary, NTO IRE-Polus, to Rusnano for \$25.0 million. Terms of the investment allow Rusnano to put the investment to the Company for redemption in either cash or our stock, at the option of Rusnano, from December 2015 to December 2017. The Company also has certain rights to call the investment from December 2013 to December 2017. In addition, the Company has rights to call the investment at any time if the Company is no longer permitted to consolidate the financial results of NTO IRE-Polus under accounting principles generally accepted in the United States of America. Furthermore, if Rusnano owns less than 10.01% of NTO IRE-Polus, the Company has a call option and Rusnano has a put option for Rusnano's entire share. We are required to account for the put rights on our balance sheet as a liability or other than permanent equity. Rusnano purchased an additional 10% of our Russian subsidiary in June 2011 for \$20.0

million as NTO IRE-Polus attained certain minimum revenue thresholds. This additional investment is also subject to the put and call provisions described above. See Note 8 in Notes to Consolidated Financial Statements.

*Operating activities.* Net cash provided by operating activities increased by \$3.6 million to \$27.0 million for the six months ended June 30, 2011 from \$23.4 million for the six months ended June 30, 2010, primarily resulting from:

An increase in cash provided by net income after adding back non-cash charges of \$60.8 million in the six months ended June 30, 2011 as compared to the same period in 2010; partially offset by

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An increase in inventory of \$35.2 million in the six months ended June 30, 2011 compared to an increase of inventory of \$9.5 million in the six months ended June 30, 2010; and  
 A decrease in accrued expenses and other liabilities of \$2.7 million in the six months ended June 30, 2011 compared to an increase of \$13.2 million in the six months ended June 30, 2010; and  
 A decrease in income and other taxes payable of \$4.4 million in the six months ended June 30, 2011 compared to an increase of \$2.8 million in the six months ended June 30, 2010; and  
 An increase in Accounts receivable of \$16.9 million in the six months ended June 30, 2011 compared to \$12.7 million increase in the six months ended June 30, 2010.

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 products, the rate at which we turn inventory has historically been comparatively low when compared to our cost of sales. Also, our historic growth rates required investment in inventories to support future sales and enable us to quote short delivery times to our customers, providing what we believe is a competitive advantage. Furthermore, if there was a disruption to the manufacturing capacity of any of our key technologies, our inventories of components should enable us to continue to build finished products for a period of time. We believe that we will continue to maintain a relatively high level of inventory compared to our cost of sales. As a result, we expect to have a significant amount of working capital invested in inventory. A reduction in our level of net sales or the rate of growth of our net sales from their current levels would mean that the rate at which we are able to convert our inventory into cash would decrease.

*Investing activities.* Net cash used in investing activities was \$23.1 million and \$12.7 million in the six months ended June 30, 2011 and 2010, respectively. The cash used in investing activities in 2011 related to the purchase of new buildings in Germany and Japan and start of the construction of a new building in Russia. In the six months ended June 30, 2010, cash used in investing activities was related to the purchase of a new building in South Korea to house a new laser application center, the acquisitions of Photonics Innovations Inc. and Cosytronic, KG and purchases of equipment primarily in the United States and Germany.

We expect to incur approximately \$50 million in capital expenditures, excluding acquisitions, in 2011. 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 to a later period.

*Financing activities.* Net cash provided by financing activities was \$29.7 million in the six months ended June 30, 2011 as compared to net cash provided by financing activities of \$1.1 million in the six months ended June 30, 2010. The cash provided by financing activities in 2011 was primarily related to cash received from Rusnano for a 10% interest in our Russian subsidiary and cash provided by the exercise of stock options. The cash provided by financing activities in 2010 was primarily related to the exercise of stock options and net drawings on line-of-credit facilities.

**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 year ended December 31, 2010. 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.

**Table of Contents****Recent Accounting Pronouncements**

In October 2009, the Financial Accounting Standards Board issued new accounting guidance for revenue recognition related to multiple element arrangements. This guidance established a selling price hierarchy, which allows the use of estimated selling prices to allocate arrangement consideration to deliverables in cases where neither vendor-specific objective evidence nor third-party evidence is available. The new guidance is effective for the Company prospectively for revenue arrangements entered into or materially modified beginning in the first quarter of fiscal 2011. The adoption of this accounting guidance did not have a material impact on the Company's consolidated financial statements and is not expected to have a material effect on the Company's consolidated financial statements in subsequent periods.

**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.

We are also exposed to market risk as a result of increases or decreases in the amount of interest expense we must pay on our bank debt and borrowings on our bank credit facilities. Our interest obligations on our long-term debt are fixed by means of interest rate swap agreements. Although our U.S. revolving line of credit and our Euro credit facility have variable rates, 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, the Russian Ruble, and Chinese Yuan. 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 on foreign exchange transactions totaled \$0.2 million and \$2.3 million for the three months ended June 30, 2011 and 2010, respectively. Management believes that the use of foreign currency hedging instruments reduces the risks of certain foreign currency transactions; however, these instruments provide only limited protection. We have foreign currency hedges as of June 30, 2011, however, 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.

**ITEM 4. CONTROLS AND PROCEDURES****Evaluation of Disclosure Controls and Procedures**

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 first half of 2011 with respect to those proceedings previously reported in our Annual



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Report on Form 10-K for the year ended December 31, 2010, except that the trial date for the IMRA America litigation has been set to September 2011.

**ITEM 1A. RISK FACTORS**

None.

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

None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. (Removed and Reserved)**

**ITEM 5. OTHER INFORMATION**

None.

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**ITEM 6. EXHIBITS**

(a) Exhibits

**Exhibit**

| <b>No.</b> | <b>Description</b>                                                                            |
|------------|-----------------------------------------------------------------------------------------------|
| 12.1       | Statement Re Computation of Earnings to Fixed Charges                                         |
| 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 |
| 101.INS    | XBRL Instance Document                                                                        |
| 101.SCH    | XBRL Taxonomy Extension Schema                                                                |
| 101.CAL    | XBRL Taxonomy Extension Calculation Linkbase                                                  |
| 101.LAB    | XBRL Taxonomy Extension Label Linkbase                                                        |
| 101.PRE    | XBRL Taxonomy Extension Presentation Linkbase                                                 |
| 101.DEF    | XBRL Taxonomy Extension Definition Linkbase                                                   |

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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: August 8, 2011

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

Date: August 8, 2011

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

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