IPG PHOTONICS CORP
Form 10-Q
August 11, 2008

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

FORM 10-Q

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

For the quarterly period ended June 30, 2008

OR

o **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 þ NO o

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. (Check one):

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

As of August 6, 2008, there were 44,611,656 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

	June 30, 2008	December 31, 2007
	(In thousands, except share and per share data)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 44,926	$ 37,972
Marketable securities, at fair value		6,950
Accounts receivable, net	37,747	33,946
Inventories, net	76,574	60,412
Income taxes receivable	935	3,145
Prepaid expenses and other current assets	7,759	7,071
Deferred income taxes	8,065	6,195
Total current assets	176,006	155,691
DEFERRED INCOME TAXES	2,654	2,795
PROPERTY, PLANT AND EQUIPMENT, Net	111,207	96,369
OTHER ASSETS	13,164	8,466
TOTAL	$ 303,031	$ 263,321
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Revolving line-of-credit facilities	$ 19,850	$ 11,218
Current portion of long-term debt	1,333	
Accounts payable	9,613	9,444
Accrued expenses and other liabilities	17,313	13,160
Deferred income taxes	940	564
Income taxes payable	1,875	96
Total current liabilities	50,924	34,482
DEFERRED INCOME TAXES AND OTHER LONG-TERM LIABILITIES	2,645	4,204
LONG-TERM DEBT	18,710	20,000
COMMITMENTS AND CONTINGENCIES		
MINORITY INTERESTS	5,270	4,455
STOCKHOLDERS EQUITY:		
Common stock, $0.0001 par value, 175,000,000 shares authorized; 44,520,832 shares issued and outstanding at June 30, 2008; 44,012,341 shares issued and	4	4

outstanding at December 31, 2007		
Additional paid-in capital	277,875	275,506
Accumulated deficit	(73,796)	(90,497)
Accumulated other comprehensive income	21,399	15,167
Total stockholders equity	225,482	200,180
TOTAL	$ 303,031	$ 263,321

See notes to consolidated financial statements.

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IPG PHOTONICS CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(In thousands, except per share data)			
NET SALES	$ 55,994	$ 43,952	$ 108,870	$ 85,705
COST OF SALES	29,047	23,633	57,523	46,055
GROSS PROFIT	26,947	20,319	51,347	39,650
OPERATING EXPENSES:				
Sales and marketing	3,703	2,836	6,850	4,745
Research and development	4,447	2,388	7,321	4,517
General and administrative	6,024	4,989	11,863	9,230
Total operating expenses	14,174	10,213	26,034	18,492
OPERATING INCOME	12,773	10,106	25,313	21,158
OTHER INCOME (EXPENSE), NET:				
Interest (expense) income, net	(183)	117	(278)	513
Other income (expense), net	489	(8)	536	36
Total other income	306	109	258	549
INCOME BEFORE PROVISION FOR INCOME TAXES AND MINORITY INTERESTS IN CONSOLIDATED SUBSIDIARIES	13,079	10,215	25,571	21,707
PROVISION FOR INCOME TAXES	(4,058)	(3,611)	(8,055)	(8,118)
MINORITY INTERESTS IN CONSOLIDATED SUBSIDIARIES	(469)	(216)	(815)	(588)
NET INCOME	$ 8,552	$ 6,388	$ 16,701	$ 13,001
NET INCOME PER SHARE:				
Basic	$ 0.19	$ 0.15	$ 0.38	$ 0.30
Diluted	$ 0.19	$ 0.14	$ 0.36	$ 0.29
WEIGHTED-AVERAGE SHARES OUTSTANDING:				
Basic	44,355	42,974	44,225	42,942
Diluted	46,132	45,631	46,087	45,616

See notes to consolidated financial statements.

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IPG PHOTONICS CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30,	
	2008	2007
	(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 16,701	$ 13,001
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	7,525	5,410
Deferred income taxes	(2,934)	380
Stock-based compensation	1,004	509
Other	(518)	(384)
Provisions for inventory, warranty and bad debt	3,489	2,072
Minority interests in consolidated subsidiaries	815	588
Changes in assets and liabilities that provided (used) cash:		
Accounts receivable	(2,846)	(4,651)
Inventories	(15,751)	(11,746)
Prepaid expenses and other current assets	1,032	(2,620)
Accounts payable	(469)	2,840
Accrued expenses and other liabilities	(330)	(273)
Income and other taxes payable	3,930	(7,117)
Net cash provided by (used in) operating activities	11,648	(1,991)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property, plant, equipment and intangible assets	(20,325)	(17,859)
Proceeds from sale of property, plant and equipment	20	78
Proceeds from sale of marketable securities	5,450	
Employee and stockholder loans repaid	116	17
Net cash used in investing activities	(14,739)	(17,764)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from line-of-credit facilities	14,127	20,298
Payments on line-of-credit facilities	(6,041)	(12,118)
Proceeds from long-term borrowings	20,043	
Principal payments on long-term borrowings	(19,499)	(18,177)
Exercise of employee stock options and related tax benefit from exercise	1,365	851
Net cash provided by (used in) financing activities	9,995	(9,146)
EFFECT OF CHANGES IN EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	50	(57)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	6,954	(28,958)
CASH AND CASH EQUIVALENTS Beginning of period	37,972	75,667

CASH AND CASH EQUIVALENTS — End of period	$ 44,926	$ 46,709
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for interest	$ 849	$ 350
Income taxes paid	$ 5,026	$ 13,940
Non-cash transactions:		
Additions to property, plant and equipment included in accounts payable	$ 271	$ 198

See notes to consolidated financial statements.

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IPG PHOTONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
1. BASIS OF PRESENTATION

The accompanying unaudited interim consolidated financial statements have been prepared by IPG Photonics Corporation (IPG , we , our , or the Company). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. The consolidated financial statements include our accounts and those of our subsidiaries. All intercompany balances have been eliminated in consolidation. These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto in our annual report on Form 10-K for the year ended December 31, 2007.

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

2. RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements, or* SFAS 157, which addresses how companies measure fair value when required to use a fair value measurement for recognition or disclosure purposes under generally accepted accounting principles. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The Company has adopted the provisions of SFAS 157 as of January 1, 2008, for financial instruments. Although the adoption of SFAS 157 did not materially impact our financial condition, results of operations, or cash flow, we are now required to provide additional disclosures as part our financial statements.

SFAS 157 establishes a three-tier fair value hierarchy, which classifies the inputs used in measuring fair value. These tiers include: 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 in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

As of June 30, 2008, the Company held certain assets and liabilities that are required to be measured at fair value on a recurring basis. These included a foreign exchange forward contract and an interest rate swap with fair values determined using Level 2 of the hierarchy of ($38) and ($67), respectively and auction rate securities with fair values determined using Level 3 of the hierarchy of $1,425.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS No. 159), which provides companies with an option to report selected financial assets and liabilities at fair value. SFAS No. 159 also establishes presentation and disclosure requirements relating to the use of fair values within the financial statements. The provisions of SFAS No. 159 were effective for the Company beginning January 1, 2008. The Company did not designate any financial assets or liabilities for the accounting allowed by SFAS No. 159, and therefore there was no impact on adoption.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS No. 141 (revised 2007)), and SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements-an amendment of ARB No. 51* (SFAS No. 160). SFAS No. 141 (revised 2007) requires an acquirer to measure the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree at their fair values on the acquisition date, with goodwill being the excess value over the net identifiable assets acquired. This standard also requires the fair value measurement of certain other assets and liabilities related to the acquisition such as contingencies and research and development. SFAS No. 160 clarifies that a noncontrolling interest in a subsidiary should be reported as a component of stockholders equity in the consolidated financial statements. Consolidated net income should include the net income for both the parent and the noncontrolling interest with disclosure of both

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amounts on the consolidated statement of income. The calculation of earnings per share will continue to be based on income amounts attributable to the parent. The effective date for both statements is for fiscal years beginning after December 15, 2008. The adoption of SFAS No. 141 (revised 2007) is prospective. The adoption of SFAS No. 160 is prospective. The impact on presentation and disclosure is applied retrospectively. We are currently in the process of evaluating the impact, if any, that the adoption of SFAS No. 141 (revised 2007) and SFAS No. 160 will have on our financial position, consolidated results of operations and cash flows.

3. INVENTORIES

Inventories consist of the following (in thousands):

	June 30, 2008	December 31, 2007
Components and raw materials	$ 28,488	$ 25,363
Work-in-process	31,958	25,831
Finished goods	16,128	9,218
Total	$ 76,574	$ 60,412

4. FINANCING ARRANGEMENTS

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

	June 30, 2008	December 31, 2007
Revolving Line-of-Credit Facilities:		
Euro Credit and Overdraft Facilities	$ 2,715	$ 135
U.S. Line of Credit	17,135	11,083
Total	$ 19,850	$ 11,218
Term Debt:		
Secured Note	$ 20,043	$ 20,000
Less current portion	(1,333)	
Long-term debt	$ 18,710	$ 20,000

Revolving Line of Credit Facilities:

U.S. Line of Credit In June 2008, the Company amended its existing unsecured revolving credit facility in the U.S. increasing the availability of revolving credit under the facility to $35 million from $20 million and extending its maturity date to July 26, 2011 from June 20, 2010. The interest rate for revolving borrowings is unchanged at LIBOR plus 0.8% to 1.2% (3.25% at June 30, 2008). The facility also allows for draw downs by certain subsidiaries in their local currencies.

Term Debt:

Secured Note In June 2008, the Company entered into a $20 million term note with a bank due July 26, 2013. Proceeds from the note were used to redeem the $20 million subordinated notes. The new $20 million note is secured by a lien on the

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Company s real property and buildings in Oxford, Massachusetts and bears interest at a variable rate of LIBOR plus 0.8% to 1.2%. Concurrent with the term note, the Company and the bank entered into an interest rate swap instrument which converts the variable LIBOR rate on the term note to a fixed rate of 4.1%. The interest rate on the notes at June 30, 2008 was 4.9%. The interest rate swap has been designated a cash flow hedge under the provisions of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The fair value of the swap totaled ($67) at June 30, 2008 and is included in Deferred Income Taxes and Other Long-Term Liabilities in the Company s Consolidated Balance Sheets. The associated change in fair value is included in Accumulated Other Comprehensive Income .

5. NET INCOME PER SHARE

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Net income	$ 8,552	$ 6,388	$ 16,701	$ 13,001
Weighted average shares	44,355	42,974	44,225	42,942
Dilutive effect of common stock equivalents	1,777	2,657	1,862	2,674
Diluted weighted average common shares	46,132	45,631	46,087	45,616
Basic net income per share	$ 0.19	$ 0.15	$ 0.38	$ 0.30
Diluted net income per share	$ 0.19	$ 0.14	$ 0.36	$ 0.29

The computation of diluted weighted average common shares excludes 233,000 and 110,000 shares for the three months and six months ended June 30, 2008 and 2007, respectively, because the effect on net income per share would have been anti-dilutive.

6. COMPREHENSIVE INCOME

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Net income	$ 8,552	$ 6,388	$ 16,701	$ 13,001
Other comprehensive income:				
Unrealized loss on secured note interest rate swap	(67)		(67)	
Unrealized loss on marketable securities	(75)		(75)	
Foreign currency translation adjustment	(1)	528	6,374	1,103
Comprehensive income	$ 8,409	$ 6,916	$ 22,933	$ 14,104

7. COMMITMENTS AND CONTINGENCIES

In November 2006, the Company was sued for patent infringement relating to certain unspecified fiber amplifier products. The plaintiff has made a complaint for damages of over $10 million, treble damages for alleged willful infringement and injunctive relief. Trial had been set for August 5, 2008. In June 2008, the U.S. Patent and Trademark Office (USPTO) ordered re-examination of the patent claims asserted by the plaintiff against the Company based on several prior art references that we submitted in an *ex parte* re-examination request. The U.S. District Court for the

Eastern District of Michigan had previously stayed the litigation until the conclusion of the re-examination. The Company believes it has meritorious defenses and intends to vigorously contest the claims. As such, no amounts have been accrued in respect of this contingency.

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In February 2008, the Company was sued for patent infringement relating to two product lines used in medical laser applications. The plaintiff has filed a complaint for unspecified damages, treble damages for alleged willful infringement and injunctive relief. The patent asserted in the lawsuit expired in April 2007. In July 2008, the USPTO ordered re-examination of the patents asserted by the plaintiff against the Company and other defendants in the action based on several prior art references submitted in an *ex parte* re-examination request. The Company believes it has meritorious defenses and intends to vigorously contest the claims as more fully described in Part II, Item 1, Legal Proceedings. As such, no amounts have been accrued in respect to this contingency.

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

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

Overview

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

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

Factors and Trends That Affect Our Operations and Financial Results

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

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

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, and by other factors, some of which are not under our control. Our product mix affects our margins because the selling price per watt is higher for low and mid-power devices than for high-power devices. The overall cost of high-power lasers may be partially offset by improved absorption of fixed overhead costs associated with sales of larger volumes of higher-power products.

Due to the fact that we have high fixed costs, our costs are difficult to adjust in response to changes in demand. In addition, our fixed costs will increase as we expand our capacity. Gross margins generally have improved because of greater absorption of fixed overhead costs associated with an increase in sales. In addition, absorption of fixed costs can benefit gross margins due to an increase in production that is not sold and placed into inventory. Absorption of fixed costs can adversely impact gross margins if there is lower production and a decrease in inventory that is sold. If the rate at which our fixed costs increases is greater than the growth rate of our net sales or if we have production issues or inventory write-downs, our gross margins could be negatively affected. We also regularly review our inventory for items that are slow-moving, have been rendered obsolete or determined to be excess, and any write-off of such slow-moving, obsolete or excess inventory affects our gross margins.

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 continue to increase as we expand headcount to support the growth of our company, comply with public company reporting obligations and regulatory requirements and continue to invest in our financial reporting systems. We expect future increases in these expenses to be more moderate than those that we experienced in 2007. Legal expenses vary based upon the stage of litigation, including patent re-examinations, and are expected to increase in the pending litigations as the discovery and trial phases of these litigations occur. Litigation expenses also may increase in response to any future litigation or intellectual property matters, the timing and amount of which may vary substantially from quarter to quarter.

Major customers. We have historically depended on a few customers for a large percentage of our annual net sales. The composition of this group can change from year to year. Net sales derived from our five largest customers as a percentage of our annual net sales were 37% in 2005, 29% in 2006, 20% in 2007 and 21% for the six months ended June 30, 2008. Sales to our largest customer accounted for 13%, 10%, 7% and 7% of our net sales in 2005, 2006, 2007 and the six months ended June 30, 2008, respectively. We seek to add new customers and to expand our relationships with existing customers. We anticipate that the composition of our net sales to our significant customers will continue to change. If any of our significant customers were to substantially reduce their purchases from us, our results would be adversely affected.

Results of operations for the three months ended June 30, 2008, compared to the three months ended June 30, 2007

Net sales. Net sales increased by $12.0 million, or 27.4%, to $56.0 million for the three months ended June 30, 2008 from $44.0 million for the three months ended June 30, 2007. The increase was attributable to higher sales of fiber lasers in materials processing applications, where net sales increased by $13.9 million, or 41.9%, advanced applications, where net sales increased by $0.6 million, or 11.5%, and communications applications, where net sales increased by $0.5 million, or 28.1%. These increases were partially offset by a decrease in sales in medical applications of $3.0 million, or 75.9%. The growth in materials processing applications and advanced applications sales resulted primarily from increased sales of pulsed lasers and medium-power lasers and continued market penetration for high-power fiber lasers. The increase in communications applications sales was due to higher sales of telecommunications systems in Russia. The decrease in sales of medical applications was due to lower sales to our largest customer for this application in the United States and resulted in a decrease in sales of low-power lasers.

Cost of sales and gross margin. Cost of sales increased by $5.4 million, or 22.9%, to $29.0 million for the three months ended June 30, 2008 from $23.6 million for the three months ended June 30, 2007 as a result of increased sales volume. Our gross margin increased to 48.1% for the three months ended June 30, 2008 from 46.2% for the three months ended June 30, 2007. The increase in gross margin was the result of favorable absorption of our fixed manufacturing costs due to high production volumes, part of which was placed into inventories, and favorable product mix related to the increase in sales of medium-power lasers in the quarter ended June 30, 2008. In addition, we recognized approximately $0.5 million of deferred revenue with no associated cost.

Sales and marketing expense. Sales and marketing expense increased by $0.9 million, or 30.6%, to $3.7 million for the three months ended June 30, 2008 from $2.8 million for the three months ended June 30, 2007, primarily as a result of an increase of $0.4 million in personnel costs related to the expansion of our worldwide direct sales organization, including additional sales personnel in the United States, Germany and Japan. Additionally, the increase resulted from

a $0.2 million increase in costs related to units used for demonstration purposes. As a percentage of sales, sales and marketing expense remained consistent at 6.6% for the three months ended June 30, 2008 compared to 6.5% for the three months ended June 30, 2007. As we continue to expand our worldwide sales organization, we expect expenditures on sales and marketing to continue to increase in the aggregate.

Research and development expense. Research and development expense increased by $2.0 million, or 86.2%, to $4.4 million for the three months ended June 30, 2008 from $2.4 million for the three months ended June 30, 2007. This increase was primarily due to an increase of $1.1 million in personnel costs and $0.8 million in materials used for research and development projects. During 2008, we increased the number of personnel performing research and development activities in the United States, Germany and Russia, our three principal research locations. Increases in material used for research and development related primarily to the United States and Russia. In the United States, material use was driven by activities related to new product development, and in Russia, the increase was driven primarily by supplies related to a new research lab. Research and development activity continues to focus on enhancing the performance of our internally manufactured components, refining production processes to improve manufacturing yields and the development of new products operating at different wavelengths and at higher output powers. As a percentage of sales, research and development expense increased to 7.9% for the three months ended June 30, 2008 from 5.4% for the three months ended June 30, 2007.

General and administrative expense. General and administrative expense increased by $1.0 million, or 20.7%, to $6.0 million for the three months ended June 30, 2008 from $5.0 million for the three months ended June 30, 2007, primarily due to an increase of $0.6 million in personnel expenses as we expanded the general and administrative function to support the growth of the business and $0.3 million of realized and unrealized losses related to foreign currency. As a percentage of sales, general and administrative expense decreased to 10.8% for the three months ended June 30, 2008 from 11.4% for the three months ended June 30, 2007.

Interest (expense) income, net. Interest (expense) income, net was $0.2 million of net interest expense for the three months ended June 30, 2008 compared to $0.1 million of net interest income for the three months ended June 30, 2007. The change in interest (expense) income, net resulted from higher interest expense due to utilization of credit lines.

Other income (expense), net. Other income (expense), net was $0.5 million of net other income for the three months ended June 30, 2008 compared to $8,000 of net other expense for the three months ended June 30, 2007. The increase in income related primarily to a $0.5 million gain on the extinguishment of subordinated debt.

Provision for income taxes. Provision for income taxes increased by $0.5 million to $4.1 million for the three months ended June 30, 2008 from $3.6 million for the three months ended June 30, 2007, representing an effective tax rate of 31.0% for the three months ended June 30, 2008 as compared to an effective tax rate of 35.3% for the three months ended June 30, 2007. The decrease is primarily due to a change in income tax rates in Germany from 38% to approximately 30% which became effective on January 1, 2008.

Net income. Net income increased by $2.2 million, or 33.9%, to $8.6 million for the three months ended June 30, 2008 from $6.4 million for the three months ended June 30, 2007. Net income as a percentage of our net sales increased by 0.8 percentage points to 15.3% for the three months ended June 30, 2008 from 14.5% for the three months ended June 30, 2007 due to the aforementioned factors.

Results of operations for the six months ended June 30, 2008, compared to the six months ended June 30, 2007

Net sales. Net sales increased by $23.2 million, or 27.0%, to $108.9 million for the six months ended June 30, 2008 from $85.7 million for the six months ended June 30, 2007. The increase was attributable to higher sales of fiber lasers in materials processing applications, where net sales increased by $25.2 million, or 38.2%, advanced applications, where net sales increased by $1.3 million, or 13.6%, and communications applications, where net sales increased by $1.2 million, or 28.4%. These increases were partially offset by a decrease in sales in medical applications of $4.5 million, or 76.3%. The growth in materials processing applications and advanced applications sales resulted primarily

from increased sales of pulsed lasers and medium-power lasers and continued market penetration for high-power fiber lasers. The increase in communications applications sales was due to higher sales of telecommunications systems in Russia. The decrease in sales of medical applications was due to lower sales to our largest customer for this application in the United States and resulted in a decrease in sales of low-power lasers.

Cost of sales and gross margin. Cost of sales increased by $11.4 million, or 24.9%, to $57.5 million for the six months ended June 30, 2008 from $46.1 million for the six months ended June 30, 2007 as a result of increased sales volume. Our gross margin increased to 47.2% for the six months ended June 30, 2008 from 46.3% for the six months ended June 30, 2007. The increase in gross margin was the result of favorable absorption of our fixed manufacturing costs due to high production volumes, part of which was placed into inventories, and favorable product mix in the six months ended June 30, 2008.

Sales and marketing expense. Sales and marketing expense increased by $2.2 million, or 44.4%, to $6.9 million for the six months ended June 30, 2008 from $4.7 million for the six months ended June 30, 2007, primarily as a result of an increase of $0.9 million in personnel costs and $0.3 million in premises costs related to the expansion of our worldwide direct sales organization, including our new sales office in China and additional sales personnel in the United States, Germany and Japan. Additionally, the increase resulted from a $0.6 million increase in costs related to units used for demonstration purposes. As a percentage of sales, sales and marketing expense increased to 6.3% for the six months ended June 30, 2008 compared to 5.5% for the six months ended June 30, 2007. As we continue to expand our worldwide sales organization, we expect expenditures on sales and marketing to continue to increase in the aggregate.

Research and development expense. Research and development expense increased by $2.8 million, or 62.1%, to $7.3 million for the six months ended June 30, 2008 from $4.5 million for the six months ended June 30, 2007. This increase was primarily due to an increase of $1.7 million in personnel costs and $1.1 million in materials used for research and development projects. During