

**Protolabs Q3 2020 Conference Call – Prepared Remarks**  
**Thursday, October 29, 2020**

**Dan Schumacher**

Ladies and gentlemen, this is Dan Schumacher, Director of Investor Relations at Protolabs. Thank you for your patience this morning. We experienced difficulties with our conference call service provider. As a result we have recorded our call today. With me is Vicki Holt, our President and Chief Executive Officer, and John Way, our Chief Financial Officer. This morning, before the market open, Protolabs issued a press release announcing its financial results for the third quarter ended September 30, 2020. The release is available on the Company's website at [protolabs.com](http://protolabs.com). In addition, a prepared slide presentation is available online at the web address provided in our press release.

Before we begin, I would like to remind everyone that our discussion will include statements relating to future performance and expectations that are or may be considered forward-looking statements and subject to risks and uncertainties that could cause actual results to differ materially from expectations. Please refer to our earnings press release and recent SEC filings, including our Annual Report on Form 10-K, for information on certain risks that could cause actual outcomes to differ materially and adversely from any forward-looking statements made today.

The results and guidance we will discuss include non-GAAP financial measures consistent with our past practice. Please refer to our press release and the accompanying slide presentation within the Investor

Relations section of our company web site for a complete reconciliation of non-GAAP to GAAP results.

Now I'd like to turn the call over to Vicki Holt, President and Chief Executive Officer of Protolabs. Vicki.

## **Vicki Holt**

Thanks Dan, and good morning everyone. Thank you for joining us today for our third quarter earnings conference call.

Our agenda includes a brief overview of our financial and business performance during the third quarter and how we continue to manage through the COVID-19 pandemic, as well as an update on our Protolabs 2.0 systems project. I will then turn the call over to John for additional insight into our financial results and our outlook for the fourth quarter.

Before I touch on our financials and business performance, I'd like to express how proud I am with how our teams have worked together and continue to perform in a complex and challenging environment. As has been the case throughout 2020, our top priority is to keep our employees, communities, and customers safe, while continuing to delight our customers with our market-leading digital manufacturing services. Our organization has continually adapted to near term changes, guided by our core values of Teamwork, Trust, and Achievement.

The uncertainty in 2020 has sparked rapid change, and our colleagues have shown extreme dedication and resilience as we continue to focus on what we can control within our business during this global pandemic. I want to thank each and every one of our employees for everything they do to make Protolabs a great company.

### **Q3 2020 Results**

Turning to our financial results for the third quarter. I'm pleased to share that we delivered third quarter revenue and earnings per share above expectations, driven by the compounding impacts of revenue at the high end of our guidance range, improved productivity, and lower costs. We reported third quarter revenue of \$108 million, representing a year-over-year decline of 8%, and a 1% increase over the second quarter of 2020. Our year-over-year revenue decline is a result of continued global economic challenges and their impact on our customer base.

COVID-19 related revenue in the third quarter was \$3 million, down from \$12 million in the second quarter. As a reminder, our orders related to COVID-19 include parts for ventilators and diagnostic equipment, as well as personal protective equipment for healthcare providers. We are grateful that we have been able to contribute to the response to COVID-19.

During the third quarter, we saw slight progressive improvement in revenue month-to-month. This trend of sequential improvement aligns with macroeconomic data in the third quarter, which indicates a continued gradual global recovery, yet global and US industrial and manufacturing

activity remain below pre-pandemic levels. We served nearly 19,000 unique product developers in the most recent quarter, representing companies of many different sizes from many different industries. Within our very broad customer base, some companies are back to normal operations, but many continue to recover from mandated closures and stay-at-home orders which resulted in decreased demand for their products, as well as the trickle-down effect of project funding reductions and timing delays.

I will now transition to third quarter 2020 revenue by geography, highlighted on slide 5 of our Earnings Presentation:

- Americas revenue declined (1)% compared to the second quarter of 2020. The vast majority of our COVID related orders were generated in the Americas, and therefore this region saw the greatest impact from the \$9 million decline in COVID orders from Q2 to Q3. Excluding the COVID orders, the underlying business trend in the Americas showed progressive improvement. The economic challenges are broad-sweeping as all of our top US customer end markets were flat or down year-over-year in the third quarter. From a year-over-year growth perspective, aerospace has been our best performing customer industry in the Americas this year. Space exploration and satellite projects and funding continue at a rapid pace and our quick-turn digital manufacturing services continue to be extremely valuable for customers in that industry.

- Europe third quarter revenue declined 9% year-over-year, or 13% in constant currencies, but improved 13% sequentially as the European markets begin to recover. Our European medical customer industry was flat, while the remaining top customer industries declined compared to last year.
- In Japan, revenue declined 22% in constant currencies. Japan's economy continues to struggle, and the country's manufacturing Purchasing Managers' Index indicates the sector now has contracted for 17 months in a row.
- Overall, our business declined 9% year-over-year in constant currencies during the third quarter of 2020, but the underlying business performance improved sequentially with the macroeconomic trends.

Revenue by service for the third quarter is presented on slide 6 of our earnings presentation. Injection molding revenue declined 3% compared to the same period in 2019. Excluding COVID-19 revenue, injection molding was down 9% year-over-year. Our 3D Printing business performed very well in the quarter, growing 2% over the third quarter of 2019, and 14% sequentially. CNC and sheet metal both declined double digits year-over-year, consistent with second quarter performance.

On the expense side, as the challenges and uncertainty of 2020 continue, we remain focused on what we can control. We are managing costs to the levels of demand that we experience on a daily basis. Our

plant managers and operations teams have done an excellent job of staffing our manufacturing facilities to predicted demand, then quickly responding to actual customer ordering levels. This increased focus and execution on controlling our costs resulted in significant gross margin improvement to 51.7%, from 50.1% the second quarter, on a Non-GAAP basis.

Turning to earnings, we reported third quarter Non-GAAP EPS of \$0.67 per share, up \$0.07 from the second quarter of 2020. Our earnings in the third quarter were up sequentially due to diligent cost management throughout the business. Our teams are carefully evaluating all spending in order to drive efficiency, considering the new working environments at Protolabs and among our customers. John will provide further insights into our third quarter financial performance a little later on the call.

## **Update on 2.0**

Our top priority entering 2020 was Protolabs 2.0, an evolution of our ecommerce quoting platform and our back-end systems that was initiated by a desire to better serve our customers. The emergence of a global pandemic in the first quarter meant that our priorities shifted; while our top priority became the health and safety of our employees, communities, and customers, our dynamic teams have continued work on Protolabs 2.0 at an energetic pace, despite having to adapt to remote working environments. We have continued investing in and executing on this significant strategic project, forging ahead with development, documentation, validation,

training, and testing. Thanks to the hard work of the dedicated Protolabs organization, we are on track to go live in Europe in November, followed by a US debut in Q1. We are incredibly excited to introduce our new ecommerce digital manufacturing quoting experience to customers, and our employees are anxious to begin working with the improved functionality and interconnectivity of our back end systems that support our operations.

Protolabs 2.0 will offer a much-improved customer experience. The new online quoting platform is more intuitive than our legacy platform, with fewer clicks required to place an order and an overall better buying experience. In addition to a modern, user-friendly interface, the new ecommerce platform provides the ability for users to better manage their project requirements, collaborate easier with colleagues, and experience new levels of transparency into their orders. In addition, our signature interactive design for manufacturability, or DFM, analysis is more intuitive than ever before.

As the economy continues its gradual recovery and we serve up a new and improved customer experience, we expect higher customer satisfaction and retention moving forward. We revolutionized manufacturing two decades ago by automating the traditional manufacturing process. With this new platform, we will continue to revolutionize the buying experience for our customers. Protolabs 2.0 will allow us to maintain and extend our position as the leader in digital manufacturing.

In summary, our business model continues to produce strong cash flows and our solid financial foundation and healthy balance sheet have enabled us to continue to invest in our future in this uncertain environment. We will continue to flex costs where we can to match demand, but we have demonstrated through our Protolabs 2.0 efforts that we will continue to invest in the long term growth of the company. With our new and improved customer experience, we will help our customers succeed and capture additional demand as individuals and companies re-accelerate development projects as momentum builds in the recovery.

Now I will turn the call over to John for an in-depth look at our financial performance in the third quarter, as well as our outlook for the final quarter of 2020.

**John Way**

### **Q3 2020 Financial Details**

Thank you Vicki. Our third quarter financial results begin on page 8 of our presentation. We reported third quarter revenue of \$107.5 million, a decrease of \$10 million, or 8.5%, over the same quarter in 2019. Our revenue declined 9.2% year-over-year in constant currencies, as foreign currency represented an \$860,000 benefit in the quarter.

We served 18,800 unique product developers in the third quarter, a sequential increase of 10%, but down 12% year-over-year. As Vicki



mentioned, though some customers have returned to normal levels of demand and production, many are still seeing continued impacts to their businesses.

Turning to slide 10 and our detailed income statement, our Non-GAAP cost of revenue decreased \$1.3 million compared to the second quarter, while our revenue increased \$900,000 sequentially. This improvement reflects the focused efforts of our operations teams to align staffing to daily variability in demand across our manufacturing services. Our non-GAAP gross margin in the quarter was 51.7%, compared to 50.1% in the second quarter, and 51.5% in the third quarter of 2019. I am very proud of the work our plant managers and operations teams have done to control costs while continuing to delight our customers, maintaining quality and on-time delivery on par with Protolabs' standards.

Turning to operating expenses, our total Non-GAAP operating expenses totaled \$33.3 million in the quarter, down \$1.4 million sequentially. As we described in our first and second quarter calls, we have eliminated essentially all of our discretionary spend, and are prudently managing costs given the uncertain nature of the current industrial demand environment. Non-GAAP operating expense as a percent of revenue in the quarter was 30.9%, down from 32.5% last quarter.

In Sales and Marketing we continue to focus on the marketing activities that are most effective, while pulling back on spend that is inefficient in the current environment.

The remaining sequential reductions in operating expenses were predominantly driven by timing of vacation usage, lower medical expense and lower incentive compensation accruals.

GAAP operating income was \$17.7 million or 16.4% of revenue in the third quarter. This compares to \$14.4 million in the second quarter

Adjusted Non-GAAP operating income was \$22.4 million or 20.8% of revenue, up significantly from \$18.7 million in the prior quarter. This strong financial performance was driven by prudent cost management while continuing to invest in our future through Protolabs 2.0.

Third quarter adjusted EBITDA was \$30.0 million, or 27.9% of revenue, up from 27.5% of revenue in the same period of the prior year, and up from 24.5% in the second quarter.

Our third quarter non-GAAP tax rate was 22.0%, consistent with our expectations, and up slightly from 21.5% in the third quarter of 2019.

On a GAAP reporting basis, net income totaled \$14.7 million, resulting in diluted earnings per share of \$0.55. Adjusting for the after-tax costs of stock compensation, amortization of intangibles, and unrealized foreign currency gains, our non-GAAP diluted earnings per share in the quarter were \$0.67, representing a \$0.09 per share decrease from the prior year, and a sequential increase of \$0.07 per share. Breaking down the sequential increase in earnings per share further, improvements in gross margin represented a benefit of \$0.06 per share, and lower operating

expenses delivered a benefit of \$0.04. These increases were partially offset by \$0.03 per share related to the higher effective tax rate than Q2.

Now turning to cash flow on slide 11...

We generated \$29.0 million in cash from operations during the quarter. Capital spend in the third quarter was \$7.2 million, including continued investments in Protolabs 2.0. Our business produces very strong free cash flows even when revenue growth is not at historical levels due to the digital nature of our manufacturing operations and less investment required for additional equipment.

Our cash and marketable securities balance now exceeds \$200 million, up from \$175 million at the end of the second quarter. Consistent with previous quarters, our balance sheet remains free of debt.

## **Q4 Outlook**

Now turning to fourth quarter guidance. Consistent with our second quarter earnings call in July, we will provide formal revenue guidance, along with a qualitative summary of our expectations for costs in the fourth quarter of 2020.

Our fourth quarter 2020 guidance is summarized on slide 16.

We currently expect fourth quarter revenue to be in the range of \$96 million to \$106 million, compared to \$107.5 million in the third quarter. The third quarter included \$3 million of COVID related orders, and we expect less COVID related revenue in the fourth quarter. Additionally, our fourth quarter revenue tends to be lower than the third quarter due to our normal seasonality pattern, caused in part by the holiday season. In 2019, we experienced a \$5.5 million sequential decline in revenue from Q3 to Q4. As Vicki mentioned, we saw slight progressive month-to-month improvement through the third quarter. October revenue trends have remained fairly consistent with September. With the ongoing uncertainty related to the global pandemic and its impact on our customer base, combined with the US presidential election, Brexit, and the quick-turn nature of our business, we continue to forecast a broad range for the remainder for the year.

Now, turning to expenses.

- As we did in the third quarter, we will continue to manage our cost structure in response to revenue levels in each of our services.
- We expect our Non-GAAP fourth quarter gross margin to be approximately 51% plus or minus 50 basis points. Our gross margin forecast is slightly lower than Q3 as we factor in seasonally lower revenue, holiday pay, and potential inefficiencies in our operations in Europe as the teams begin working with our new systems.
- Turning to operating expense, we expect our non-GAAP selling, general and administrative expenses to be between \$36 and \$37 million. These projected expenses include approximately \$3 million

in the fourth quarter related to the launch of Protolabs 2.0, consisting of \$750,000 of depreciation in the quarter as the system is placed into service, and approximately \$2.0 million related to costs of employees and contractors working on the project. The spend associated with the individuals working on the project is capitalized prior to the system launch, but will convert to expense when the system is placed in service. The remaining amount consists of overtime and training of employees to ease the transition to working in the new systems.

- Outside of the Protolabs 2.0 costs, we expect to manage our Non-GAAP operating costs generally in-line with third quarter levels.
- Our non-GAAP pre-tax add-backs in the fourth quarter will include stock compensation costs of approximately \$4.0 million and amortization of approximately \$750,000.
- We currently estimate our non-GAAP tax rate to be between 19.0% and 20.0% in the fourth quarter.

In addition to the expense in Q4, I also want to outline the impact of Protolabs 2.0 on our operating expenses in 2021. We anticipate the quarterly depreciation will be approximately \$1.5 million of expense beginning in the first quarter of 2021. In addition, we currently estimate the employee and contractor expenses will increase from \$2 million to approximately \$3 million in the first quarter with these resources expensed for the full quarter. As we progress through the year, our Protolabs employees will shift to other R&D projects while many of the contractors will roll off.

I will now turn the call over to Vicki for some final comments.

## **Vicki Holt**

Thank you John. 2020 has been a difficult year for many of us. For Protolabs, all of our employees have adapted to new methods of working while continuing to provide customers the world-class digital manufacturing services they have come to expect from Protolabs. We have done a wonderful job of adapting to volatility created in 2020.

As future demand remains uncertain, we will continue to adjust our cost structure and prudently manage the business performance in the short term. However, we will continue to drive the business ahead and invest to ensure our position as the digital manufacturing leader. Protolabs 2.0 will build on our twenty year history as the digital manufacturing leader, as we revolutionize the industry we created. Along with a new and improved customer-facing ecommerce platform, we are the only prototype and low-volume manufacturer using truly differentiated digital manufacturing processes, allowing us to separate from the competition with a strong, resilient business model.

I want to thank everyone for your time and I want to thank Protolabs employees for their extraordinary efforts through the first three quarters of 2020 and during these very uncertain times. I also want to thank our customers for their continued support. We will continue our efforts to improve our offering to customers and our financial performance. Over the long-term, we are committed to serving our customers and driving

shareholder value. We look forward to reporting to you on our progress during our next call. Thank you.