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Cognex Corp. (CGNX)

Q1 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings and welcome to Cognex First Quarter 2018 Earnings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, John Curran, Senior Vice President and Chief Financial Officer of Cognex. Please proceed.

John J. Curran

Chief Financial Officer & Executive Vice President-Finance & Administration, Cognex Corp.

Thank you and good evening, everyone. I'm John Curran, Cognex's CFO, and I'd like to welcome you to our first quarter earnings conference call. With me on today's call are Dr. Bob Shillman, Cognex's Chairman, and Rob Willett, Cognex's President and CEO.

Please note that our earnings release and Form 10-Q are available on the Cognex website at www.cognex.com. Both contain detailed information about our financial results.

During the call, we may use a non-GAAP financial measure that we believe it is useful to investors or if we believe it will help investors better understand our results or business trend. You can see a reconciliation of certain items from GAAP to non-GAAP in Exhibit 2 of the earnings release.

Any forward-looking statements we made in the earnings release or any that we may make during this call are based upon information that we believe to be true as of today. Things can change, however, and actual results may differ materially from those projected or anticipated. You should refer to the company's SEC filings, including our most recent Form 10-K, for a detailed list of these risk factors.

With that, I will now turn the call over to Dr. Bob.

Dr. Robert J. Shillman

Chairman, Founder, Chief Culture Officer and Executive Director, Cognex Corp.

Yes. Thanks, John. Hello, everyone, and thank you all for joining us today. As shown in today's earnings release, we reported solid results for the first quarter of 2018 which are in line with our expectations. Despite a pullback that we've seen with respect to consumer electronics, our overall business remains strong following dramatic growth in 2017.

As those of you who have been on the call in the past know, I'm typically available for questions during the Q&A period after the formal presentation. But, unfortunately, I need to attend a very important meeting and therefore, I have to leave the call quite soon.

So, I will now turn the call over to my partner, Rob Willett, who will provide some key details of this quarter. Rob, take the microphone. It's yours.

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

Thank you, Dr. Bob, and good evening, everyone. This year, Q1 revenue was \$170 million, squarely in the middle of our guidance and representing year-on-year growth of 22%. Operating expenses grew faster than revenue in Q1 and that was reflected in our operating margin. We expect that 2018 will follow our typical seasonal trend and that Q1 is our lowest revenue quarter and includes the highest level of expenses as a percentage of revenue.

In Q2, operating margin is expected to expand due to higher anticipated revenue, and RD&E and SG&A will come down as a percentage of revenue. Overall, market conditions remain very good across virtually all geographic areas and industry verticals except for consumer electronics, our largest industry vertical. A handful of large customers in OLED display and smartphone manufacturing appear to be investing less in automation this year after an exceptionally strong 2017. As such, we will face tough comparisons in the second half of this year.

Regarding our two fastest growing areas, revenue from logistics and 3D products, continues to grow quickly. Combined, they represented roughly 15% of our total business in Q1, up from less than 10% in Q1 of 2017. We expect both to be growth drivers for us over the long-term.

We are pleased to share with you an updated view of our served market. We now estimate the size of our served market to be \$3.5 billion, which is 20% higher than our previous estimate first shared with you in September of 2016. Notably, this increase reflects upward revisions for both logistics and 3D.

Since our last update 18 months ago, our understanding of these emerging areas has increased; plus new technology introduced by Cognex enables us to address more applications in most sectors we have chosen to serve. Overall, we believe our served market will grow in the high single-digits in the coming years.

We expect to continue to outperform market growth as a result of our superior technology and the strength of our customer relationships. Together, they provide the foundation for our long-term strategy which is to gain share in applications we currently serve and to expand into adjacent markets that we believe are of a high growth potential and high margin opportunities for Cognex machine vision.

You can see the updated market view on the Investor Relations section of our website at www.cognex.com/investor.

Turning now to new product development. We've had a busy start to the year, launching two new products that broaden the applications we serve. Our new DataMan 470 series of high-performance barcode readers expand the opportunity for Cognex vision with customers in general manufacturing industries and logistics.

With unmatched performance and a user-friendly interface, DataMan 470 sets a new industry standard for accurate, simultaneous reading of challenging 1-D and 2-D codes and multiple mixed symbologies even when they're closely spaced on high-speed production lines and conveyor systems.

We also launched the MX-1502 ER, a new extended range addition to our vision-enabled mobile terminal product range, capable of reading codes in quick succession from as near as 6 inches to as far away as 30 feet. With the MX-1502 ER, manufacturing and warehouse applications requiring near/far scanning are now also addressable with the MX product family.

I will now turn the call over to John for some financial details from the first quarter.

John J. Curran

Chief Financial Officer & Executive Vice President-Finance & Administration, Cognex Corp.

Thank you, Rob. Let me start by reviewing the new revenue standard that took effect on January 1. As we mentioned on our Q4 call, the primary impact for Cognex is how we account for sales of certain accessories which we historically reported on a net basis and now report on a gross basis. This change has resulted in our revenue and cost of goods sold increasing by the same amount.

Our gross margin dollars have not changed, but our gross margin percentage has decreased from historical rates by 100 basis points to 200 basis points. Our Q1 earnings release and all our discussions today reflect the retroactive adoption of this new standard.

Turning now to Q1, here are the highlights. As mentioned, Q1 revenue was on target at \$170 million. Gross margin was 76% in line with our expectation and down 1 percentage point year-on-year. This decrease was mainly a result of a slightly higher proportion of service revenue related to large orders from logistics.

Operating expenses for Q1 were \$95 million, representing a 37% increase from Q1 of last year. Consistent with our strategy, over the past year, we added to our industry-leading team of engineers and made important progress with respect to product development. In fact, Cognex continued to invest more in industrial machine vision than any competitor. We believe this will help us to sustain a technology leadership position in our served market for years to come.

Also, we invested in sales resources to support and grow our business worldwide. We now have more than 1,800 employees across the globe. While the rate of increase has slowed, we have added more than 100 new Cognoids since the start of the year.

Operating margin in Q1 was 20%, down from 27% in Q1 of 2017. This decrease reflects the strong Q1 we reported a year ago and our continued investments in engineering and sales. Excluding discrete tax items, we reported earnings of \$0.18 per share for both Q1 of 2018 and Q1 of 2017.

Looking at revenue year-on-year from a geographic perspective, overall market conditions were good globally apart from the consumer electronics industry. The Americas delivered the largest contribution to growth both in absolute dollars and in percentage terms and grew by nearly 40%. Growth was led by substantially higher revenue in the logistics market as well as higher sales to customers in several other vertical industries.

Europe continued to perform well, increasing by 30% over Q1 of 2017 with logistics, automotive and consumer products leading the way. Growth was in the high teens in constant currency. In Greater China, revenue grew by 20% year-on-year over a very strong quarter a year ago that included significant revenue from consumer electronics. And finally, revenue from our other Asia region declined in the low teens from Q1 of 2017, which also featured strong revenue from the consumer electronics market in Korea.

Moving on to our stock buyback program, we repurchased 1.3 million shares in Q1. We plan to continue to buy back stock in Q2, subject to market conditions and other factors. In addition, tonight, we announced a cash dividend of \$0.045 payable this quarter.

Our balance sheet continues to be in great shape. We have sufficient capital to support our organic growth plans, M&A and for returning value to our investors through stock buybacks and dividends.

With that, I will now turn the call back to Rob.

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

Thank you, John. Looking ahead, we expect Q2 revenue to be between \$200 million and \$210 million, which, at the midpoint, represents growth of 15% year-on-year. Regarding consumer electronics, slower trends compared to the unusual growth we experienced last year lead us to believe that revenue from that market segment will decline in 2018. As a result, Cognex revenue for the next three quarters in total will be relatively flat with revenue over the same period in 2017.

Gross margin is expected to be in the mid-70% range. We expect operating expenses to be essentially flat on a sequential basis. Lastly, the effective tax rate is expected to be 15% excluding discrete tax items.

In summary, despite softness in consumer electronics, we had a good start to the year. Our overall business is solid and we are positioned well for both the near term and the long-term.

We will now open the call to questions. Operator, please go ahead.

QUESTION AND ANSWER SECTION

Operator: At this time, we will be conducting a question-and-answer session. During the Q&A session, please limit yourself to one question and one follow-up before getting back into the queue. [Operator Instructions] Our first question is with Richard Eastman with Robert W. Baird. Please proceed with your question.

Richard Eastman

Managing Director, Robert W. Baird & Co., Inc.

Yes, good afternoon. A couple of things that we – can I just ask about the automotive business in particular? Maybe what – how that looked year-over-year from a growth perspective? And then also, is that – is the gain on the automotive side of the growth in your automotive side, is it coming out of the EV category or is it more traditional automotive?

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

Hi, Rick. Yeah. Okay. So, as you know, automotive is an important part of Cognex and we were pleased to see automotive deliver another strong quarter in Q1. We outperformed our expectation really in all regions and we had a growth rate significantly above our expected 10% or so long-term growth rate. So, automotive continues to look very strong.

If you look by region, the Americas increased at the fastest rate of our major geographic regions. In China, automotive grew quicker than we'd expect for the industry over the long-term and Europe provided the largest contribution in absolute dollars.

Moving to the other part of your question, I'd say there's a number of things driving growth; model changes towards SUVs and different form factors. The one you asked about, electric and hybrid engines and increasing electronic components and systems are all driving growth for our industry.

Richard Eastman

Managing Director, Robert W. Baird & Co., Inc.

Q

Okay. And then, just a follow-up question would be around the CE side of the business. Again, trying to do the math on the second to the third and fourth quarters being flat revenue-wise. Maybe it would be suggestive that consumer electronics might be down something like 20%-ish for the full year. And I'm a little bit curious as to what your visibility might beyond that? Do you have kind of any backlog that maybe backstops that down 20% or just maybe with the visibility on the consumer electronics order magnitude decline would be?

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Yeah. So, I'll start out and then I'll invite John to talk about the percentage that you raised. Maybe as a little bit of context, consumer electronics is our largest vertical. And last year, it represented roughly 40% of our business overall. It appears this year we'll see lower investments from about half a dozen large customers in the OLED and smartphone manufacturing part of the business. And these customers represent a significant portion of our electronics revenue last year.

In terms of your question around visibility, in consumer electronics, we typically have nine to 12 months visibility into the projects that large customers would like to implement with us. So, this visibility is substantially more limited as to when we're actually going to receive the orders, in which quarter they fall into, but I would say at this point, we're starting to get clarity on the year overall, so we have that visibility.

Now, as to the sort of magnitude of the decline, John, you want to comment?

John J. Curran

Chief Financial Officer & Executive Vice President-Finance & Administration, Cognex Corp.

A

I don't think we'll come back with kind of a hard percentage, but I would say directionally, that's in the ballpark.

Richard Eastman

Managing Director, Robert W. Baird & Co., Inc.

Q

Okay. Okay. Okay. And so, what falls onto that a little bit is around automotive, so the other big piece of the total revenue. And so, again, does automotive track out at a slightly lower growth rate than what we've seen here in the first quarter? I don't know if you have the same visibility.

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

We don't generally – yeah, we don't generally give full year guidance at all and certainly not by industry.

Richard Eastman

Managing Director, Robert W. Baird & Co., Inc.

Q

Okay.

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

But I would say, Rick, I would encourage you to think about our high growth verticals that we've discussed, of course, particularly logistics which you're seeing very strong growth. So, that's certainly covering for some of the decline that we're seeing in consumer electronics.

Richard Eastman

Managing Director, Robert W. Baird & Co., Inc.

I see. Okay. Thank you. I'll get back in the queue. Thank you.

Q

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

Okay. Thank you.

A

Operator: Our next question is with Joe Giordano with Cowen & Company. Please proceed with your question.

Joseph Giordano

Analyst, Cowen & Co. LLC

Hi, guys. So, just starting on consumer electronics. Like, I know a lot of this is just math, obviously, after an explosive year last year. So, are you seeing anything that you consider slight structural changes into that market given – if we're in a slower demand for other devices like are you seeing changes in investment or more lines being turned over quickly where you can kind of use some of the same equipment? Are you seeing any of that kind of activity?

Q

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

I would say, overall, not. I think the structure of the industry hasn't changed but what has changed are the number of new end products and features planned for introduction and then certainly among our customers helping and implementing the manufacture of displays, particularly OLED displays. There's been a slowdown in terms of capital investment. So, the timing that we might have expected to come quickly, we now see coming later. But I don't think that diminishes our overall optimism about consumer electronics or the business we can do in smartphones and in displays with the major players. Unfortunately, it just means that this is a slower year after last year of being such a phenomenal year.

A

Joseph Giordano

Analyst, Cowen & Co. LLC

But you would still categorize that business as being capable on average to be at or above your longer term 20% top line growth estimate, right, for the full company?

Q

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

Yes. Yes, I would.

A

Joseph Giordano

Analyst, Cowen & Co. LLC

Okay. In regard to like OpEx, I know you're not going to get further than 2Q but the spending levels there, are they able to flex down or are you comfortable with them where they are, kind of as a run rate, broadly speaking, like – or is that something that we should expect to kind of move more in line with the directionality of revenue?

Q

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Well, I think as I mentioned in my comments, we typically see lower revenue and relatively high expenses as a percentage of revenue in Q1. So, and as also said, expect expenses to be roughly flat sequentially in Q2. So, that's kind of one thing to keep in mind.

I think another thing to keep in mind is that we're really running the business for the long-term. So, we're implementing product roadmaps that are three years in duration regularly and are based on large, long-term growth opportunities that we see. So, we wouldn't be – we don't see any reason at the moment to be

killing those or changing those substantially. And we're playing out a long-term game in that respect.

Now, certainly, RD&E is a substantial part and we spend between 10% and 15% of annual revenue on that. It was higher in the first quarter, really as a function of revenue. And in recent years, it's been on the high end of that range. Last year, I think it was around 13% overall. So, I know that's obviously something that over the long run we're managing to win in those ranges. But this is not a company that's going to be addressing, cutting long-term programs just around a quarter's operating margin.

Joseph Giordano

Analyst, Cowen & Co. LLC

Q

Yeah, certainly not. And maybe last for me. You guys came in right at the midpoint of your guidance for the quarter but was there anything – I mean, generally, that's probably internal conversation. You're probably a little upset of that like you said early on. Was it anything not come through that you were expecting or is it just consumer electronics deteriorating more than you maybe initially thought or was there anything else you'd point to that was a little surprising in the quarter?

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

No. I wouldn't say so. I mean, you're coming up to the end of the quarter. That can be timing of certain pieces of business that can tend to shift out, particularly among larger customers of ours which can be in consumer electronics and logistics but nothing especially notable.

Joseph Giordano

Analyst, Cowen & Co. LLC

Q

Okay. Great. Thanks, guys.

Operator: Our next question is with Bobby Burleson with Canaccord. Please proceed with your question.

Robert Joseph Burleson

Analyst, Canaccord Genuity, Inc.

Q

Hey, guys. Just curious for gross margins this year with consumer electronics declining. Any implications there for how we should think about product mix and any implications for gross margins this year?

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Again, we don't give guidance for the full year. So – but what I would say is I don't think there's a change. Our gross margin target is in the mid-70% range. Movement can be the result of a number of factors, including the percentage of revenue from products versus services, volume and pricing for high-volume customers.

So, there's a fair few kind of moving parts and checks and balances there. Obviously, when customers buy less, they pay higher prices in general, right? And then, in certain industries where we're getting established or we have very large, very technically-challenging customers and those that would apply for consumer electronics would also apply to logistics, we tend to have a higher percentage of service revenue. So, I think we can expect less of that going forward in consumer electronics in light of the decline of the revenue we see there, and it's partly offset by some growth of that in logistics.

But overall, I don't see any significant change to what you've seen from us in the past, obviously bracketed by the caveat of the new revenue recognition rules that John explained. So, on a constant basis, much the same.

Robert Joseph Burleson

Analyst, Canaccord Genuity, Inc.

Q

Okay. Thanks for that. And then, in terms of the addressable market, you're taking up that total – that TAM that you guys addressed. A lot of that it sounds like came from 3D and from logistics. Just wondering which one of those was the bigger contributor to you updating that view.

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Yeah. Well, if I look back, our logistics market, we've taken up by \$150 million. But I should point out to you that \$50 million of that with the moving in of airport baggage handling, which we used to report separately and now it's such a similar business to logistics we've decided to put it there. So, naturally, I guess it would be more \$100 million up.

And 3D actually has gone up double from \$200 million to \$400 million. So, the answer to your question is 3D is where we see the biggest expansion of our served market. And that's a function of our understanding the market better, seeing – or the size of the opportunities and being a much more of a competitor now in that space. We really see and I'm very enthusiastic about the opportunities.

But also we've acquired businesses and we've launched products that take us into segments of the market we weren't in before, notably profiling, which is a simpler application just [ph] emitting a line. (00:26:22) And then snapshot sensing which is really taking a picture rather than of a static object in very high definition and that's a market that I think is seeing exceptional growth and has exceptional growth outlook. Now, on two acquisitions we made in the last couple of years, EnShape and Chiaro Technologies really positions very well in that market where we really weren't a player before.

Robert Joseph Burleson

Analyst, Canaccord Genuity, Inc.

Q

And just for clarification, that market growth of the outlook for your served available market growth in the high single-digits with you guys growing faster, that includes consumer electronics?

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Yeah. It's a long-term look, so it's over a three-year period is how we would think about that. That's what we think the market will do over the long-term and that it includes everything that we serve: consumer electronics, automotive, logistics...

Robert Joseph Burleson
Analyst, Canaccord Genuity, Inc.

Q

Great. Thank you.

Robert J. Willett
President, Chief Executive Officer & Executive Director, Cognex Corp.

A

...et cetera. Thank you.

Robert Joseph Burleson
Analyst, Canaccord Genuity, Inc.

Q

Thank you.

Operator: Our next question is with [ph] Karen Lu (sic) [Karen Lau] (00:27:21) with Deutsche Bank. Please proceed with your question.

Karen K. Lau
Analyst, Deutsche Bank Securities, Inc.

Q

Thanks. Good afternoon, everyone. Just want to dig a little bit deeper into CE. Rob, your confidence or your imply or embedded outlook for CE, is that locked and loaded according to customers' project pipeline or are there still going to be movements? Can customers still change their mind in the next few months? How – I guess, how firm is that outlook at this point?

Robert J. Willett
President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Yeah. Hi, Karen. I'd say it's a pretty sensible measure to look based on all the data that we have. But what we do know about this market is things technologies can come through or not. And timing of launches of products can happen or not. So, it's not without variability, but I think we feel pretty solid about the way we've sized it now for Cognex for the rest of the year.

Karen K. Lau
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Got it. And then, I just want to dig a little bit deeper on your comments of longer term outlook for CE in the context of the 20% growth. You mentioned you still expect that to be additive to the 20%. I'm just curious, where is that growth coming from? I'm asking because the smartphone category is obviously the biggest within CE and that category – I mean, like we have sales of devices are maturing.

So, if you're growing like a 20%-plus on average per year, where is that growth coming from? Is that -- do you see just ongoing need for automation or is it just based on the pipeline of products beyond smartphone that you're seeing that customers will invest over the longer term? Can you maybe give us a little bit more color to that CE longer term outlook?

Robert J. Willett
President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Sure. So, I think there are many ways in which Cognex can and expects to grow our business in consumer electronics over the coming three years or so. So, certainly, smartphone functionality with the addition of [ph] new

more (00:29:43) technology such as we've seen in recent years, certainly there are product roadmaps that support that that we talked to a number of our customers about which would suggest to us that there's a lot more they want to do with products in terms of technology and features that will be manufacturing-intensive. So, if you look back, certainly, you can see that's happened. And for us, that drives a lot of growth potential.

The second thing is we have differing share with different smartphone manufacturers and that's been the case for Cognex since the birth of the mobile phone. We had huge share with Nokia. If you go way back and we have a large share with another large player that we don't mention by name now and there is plenty of room for – there's plenty of room for other growth in – with among other players for us in the future.

Then the third area or I would say that seems – I think we think that Cognex has a long way to run still is the big investments that we saw last year beginning in displays around AMOLED and OLED displays, which although capacity may have got out ahead of the technology -- the market's ability to absorb it this year, we still think that technology is still early in the cycle in terms of what it offers.

And even also what it offers, of course, outside of smartphones in markets like automotive or even buildings. So, we're still optimistic about that. And then we're also optimistic about the new technologies that we're bringing to market to address those areas. So, whether it's in the area of 3D, whether it's in deep learning for instance, whether it's in other developments that we have in terms of our own [indiscernible] (00:31:42) performance, we certainly see lots of opportunity for us to be bringing new features and new manufacturing benefits to customers in that space. So, we remain committed and optimistic about the space and undeterred by what we think will be a down cycle among those customers this year offsetting a very high upcycle last year.

Karen K. Lau

Analyst, Deutsche Bank Securities, Inc.

Q

Got it. Thank you. And then just one more for me. It looks like you managed to contain your OpEx to be flat sequentially despite slightly higher sales sequentially. If I backed into your full year or rest of your comment, it looks like there could still be a slight ramp in revenues from 2Q to 3Q. I think in the past, you tend to have OpEx associated with projects, so there would be a sequential increase in OpEx from 2Q to 3Q. Is that still the kind of the right assumption or do you expect to be able to contain OpEx kind of flat sequentially into the second half as well?

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Yeah. I mean, I – we don't generally think of Cognex as containing OpEx. We think about investing smart for the long-term growth of the business. And in general, we don't give outlook on OpEx for – beyond the current quarter. And I would say in general, your assumption is probably pretty good and that we wouldn't expect to see a significant increase based on history for Cognex between Q2 and Q3. That tends to be the normal pattern and I wouldn't see that changing this year.

Karen K. Lau

Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Got it. Thank you.

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Thank you.

Operator: Our next question is with Jairam Nathan with Daiwa Asset Management. Please proceed with your question.

Jairam Nathan

Analyst, Daiwa Capital Markets America, Inc.

Q

Hi. Thanks for taking my questions. And just, firstly, I just wanted to understand if the competitive structure -- competitive dynamics in the market. We are seeing quite a few, maybe not -- vision companies, maybe not directly compete with Cognex but do you -- have you seen an increase and given the market size growing, have you seen any additional competition? And how do you -- how do you make sure you don't lose share?

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Yeah. Hi. So, thanks for your question. I would say we do not see a change in the general industry dynamics in our market. And we're not -- I think I hope the impression that I've given you is that we've been gaining share and we expect to continue to gain share based on the quality and investment we make in technology and our leadership position and the customer relationships and reputation that we have.

So, I certainly see ourselves as gaining share. There's one very strong competitor that we compete with, the Japanese company, KEYENCE. And we -- the competitive dynamic with them, I would say, continues similarly to what we've seen over the past. I would say there's -- our field is still quite crowded in terms of having other competitors in the space but those competitors are underperforming -- the market leaders in that respect. And I think I see that continuing. We keep a very careful eye on new entrants into the market. There are a couple Chinese players that are getting a lot of press. We watch them very carefully but we don't see them currently making much impact from a sales or share point of view in the market.

Jairam Nathan

Analyst, Daiwa Capital Markets America, Inc.

Q

Okay. And just finally, with regard to logistics, it looked -- it seems like -- that again, there is competition from legacy companies that are present there like Honeywell. And they seem to be coming out with mobile products and all that. So, is -- and they seem to have kind of when you looked at the addressable market, I was thinking logistics will become about much bigger piece. So, what's the dynamics there? And the addressable market, it seems low compared to the market, to the opportunity.

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

All right. So, I think I'm going to start from fundamentals. So, when we talk about logistics, we're really talking for Cognex. The majority of the business today is inline reading of barcodes. So -- and then -- and that can be products moving down a production line or in a warehouse that are moving past fixed-mount readers of barcodes. And in that space, we don't really compete at all with the company that you named, although there are other more long-term serving players in that space and then we also have handheld readers that we barcode. And we specialize sort of in very high performance barcode reading using vision technology. So, that's kind of our play.

That market is growing quickly for us. So, we've been growing at a rate of 50%-plus annually. And we're seeing a very, very strong performance. And we're broadening what we do in that market to include other things, still very small in terms of revenue today but exciting; vision, so applying vision applications to do other things; looking at

the integrity of packages, the identity of packages, moving down production lines. And then also even doing other applications such as dimensioning and 3D type applications and also in future potentially robot bin picking, so to replace people working in warehouses with automation and robotics. So, those are opportunities.

Now, I got the sense from your question that possibly you're thinking about our mobile terminal business because that's the company you named is, a strong player; one of two very strong players in the market we call mobile terminals. And if you take a look at our market map, that's the gray area off to the very far right called mobile terminals which is a – we size as a \$500 million served opportunity for us where our sales today are negligible. But we expect to see significant growth and are investing.

And the product I talked about we launched, the 1502 ER, helps to round out our product range in that space. So, we now have a very full product range from all smartphone-enabled basic reading of barcodes on a basically ruggedized optics improved smartphone to ruggedized terminals to very high-end, high-performance, all of which use vision technology to improve the performance of warehouse and logistics operations. But today, that's not a big part of our business.

Jairam Nathan

Analyst, Daiwa Capital Markets America, Inc.

Okay. Thank you.

Q

Operator: Our next question is with Ethan Potasnick with Needham & Company. Please proceed with your question.

Ethan Potasnick

Analyst, Needham & Co. LLC

Hi. This is Ethan Potasnick filling in for Jim Ricchiuti. I was wondering -- so it sounds like the company made some significant additions to its sales force this past quarter as well as in the second half of last year. Can you comment on whether you're seeing reasonable levels of productivity from these new hires or is this something you would anticipate in more of the back half of the year? And then could you remind us which verticals and geographies, kind of the bulk of these sales force additions are targeting?

Q

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

Right. Yes. Thank you. So, Cognex has been investing significantly in our sales force over the last year. And that investment has gone on into the first quarter. And these are factory automation, field-based sales people; the majority of them. And they're out calling on factories, and to some degree, logistics warehouse opportunities, right?

A

We're hiring -- we've been hiring and training large quantities of them and they're coming up to speed. But in general, I think they're doing well in terms of development of their productivity. And I think that's reflected in the strong growth rate that we're seeing in the base business when we strip out consumer electronics. So, I think the 22% growth we reported in Q1 would be higher if we net it out the impact of consumer electronics. And certainly we're able to achieve that based on the increases we've made in our sales force.

But I think your question is a good one. And I think there's opportunity to increase productivity. And we're doing that with training, with development, and also with better tools; better management and IT tools so we can improve their time and territory management and hit rate when they're in front of customers.

Ethan Potasnick

Analyst, Needham & Co. LLC

Q

Okay. And then can you share any details or tell us how active your M&A pipeline is currently?

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

So, our M&A pipeline is always active. We have, as John mentioned, significant cash war chest to deploy where we see acquisition opportunities and it's not really like we are putting the foot on the gas or taking it off. We've got it on the gas all the time, but we're very selective. So, when we see opportunities – when we see markets we really like, we look at the action ability of targets within those markets and then we really need to make sure that they are companies that offer great technology, great engineers, strong growth rate, good cultural fit. So, when we find those and we can reach a deal, we move on them. We have companies we're working on currently, like we always do. And it's a question of whether they can come to fruition or not based on what the seller feels and what we discover through the process with them.

Ethan Potasnick

Analyst, Needham & Co. LLC

Q

Okay. Thank you.

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Thank you.

Operator: Our next question is with Ben Rose with Battle Road Research. Please proceed with your question.

Ben Z. Rose

Analyst, Battle Road Research Ltd.

Q

Good afternoon, Rob, and good afternoon, John. To start off, Rob, could you speak to the expected pace of new product introductions throughout the course of 2018? I know you mentioned the DataMan and MX in the first quarter, but are there others that you can discuss or there are areas as we get into the rest of the year?

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Well, Ben, thank you for the question. So, generally we don't talk about new products coming to market but we spent almost \$100 million on R&D last year. We've got phenomenal engineers, a great create pipeline and we made some great acquisitions about – a little more than a year ago. So, I think you can expect a very full and pretty exciting product pipeline coming to market over the next 12 months or so.

Ben Z. Rose

Analyst, Battle Road Research Ltd.

Q

Okay. And as a follow-up, a little different twist on the M&A question. Over the last year, most of the acquisitions and in fact, I think, all have been with sort of smaller companies, development stage companies and so forth. Is it fair to say that some of the things that are on your list of potential acquisitions might be larger in size in terms of revenue generation and so forth?

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

So – thanks, Ben. So, I think you're right that we bought companies that are small, have great engineering teams and really fit very well into what we're trying to do at Cognex and that's deliberate because we really like the way that they fit into our culture, which, as you know, it's phenomenally important to us at Cognex. And I would say in all the cases, those acquisitions we've made have gone very well. People are well-integrated, they're real Cognoids at this point, and they're happy and productive. So, that works well for us and that's – those are the acquisitions we most like to do.

However, you hinted at the shopping list. Certainly, there are companies that were targets on our shopping lists, have been for a long time that we would very much like to acquire that would require much larger investments but are not actionable and not through our lack of asking. So, that's certainly the way things are. I have no idea if and when those companies would break loose. But again, there are companies who have exceptional quality with great technology. They are not bolt-on revenue for the sake of bolt-on revenue, which is something we don't intend to do.

Ben Z. Rose

Analyst, Battle Road Research Ltd.

Q

Okay. Thanks very much for the additional color on that, Rob. And if I may, just one for John, quickly. Could you give us an update on the SAP rollout and whether it's going according to your expectations?

John J. Curran

Chief Financial Officer & Executive Vice President-Finance & Administration, Cognex Corp.

A

Sure. Yeah. The project is going well. We are on track. And we expect to light this candle next quarter.

Ben Z. Rose

Analyst, Battle Road Research Ltd.

Q

Okay. Thanks so much.

John J. Curran

Chief Financial Officer & Executive Vice President-Finance & Administration, Cognex Corp.

A

Sure.

Operator: Our next question is with Joe Ritchie with Goldman Sachs. Please proceed with your question.

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Q

Thank you. Good afternoon, guys.

A

Hey, Joe.

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Q

So, yeah. So, maybe thinking about like the cost structure for a second. I know, Rob, you said that you wouldn't stop investing in long-term programs and I fully understand why. But I guess what if – if we were in a scenario where growth started to slow, it wasn't just maybe through the back part of this year. But let's say growth was a little slower next year, how should we think about how you guys will flex your cost structure in that type of environment?

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Yeah. So, I think we've demonstrated over the history of Cognex that we're very capable of managing cost over the long-term. So, and if you look at what we did in the downturn of 2008 and 2009, we were able to take a lot of cost out. We have our own way of doing that, which is we feel very strongly. We don't want to damage the culture of the business. So, those are the quality of life here and the excitement of what we're working on. Can – [ph] we do (00:46:58) something we would [ph] guard (00:46:59) at all costs. But certainly, we can limit the number of engineering programs and we can limit the number of sales heads that we choose to add under scenarios like that. And of course, we can grow more slowly those line items which really is a matter of prioritizing certain projects over others and not pursuing them.

So, I think there's plenty of capability to do that where we just see the longer term prospects for growth slowing down. But I think when you really think about the technology and the business we're in, the application of machine vision to automation and artificial intelligence and some of the things we've been investing in, I don't think that scenario is very likely currently. But as seasoned managers, we're always ready for those events should they happen.

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Q

Yeah, that makes a lot of sense, Rob. And maybe if I were just talking – if we talked a little bit more just about CE, in your prepared comments, you talked about both OLED and smartphone demand really being the cause of the back half-weighted call it flat revenues for the rest of the year. Maybe -- can you tell us a little bit about OLED specifically, what your customers are saying about inventory levels [indiscernible] (00:48:15) you have that kind of information? And then, could you possibly size what OLED was to your revenue base in 2017?

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Yeah. Let me ask for a clarification, Joe. When you say inventory levels, are you referring to inventory levels of machine vision, perhaps? Or are you meaning their inventories of OLED material?

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Q

Yeah, more the latter and whether that then influences CapEx decision for the former.

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Yeah. So, I'm not enough authority on that subject, but what I would observe among those customers is it's more, I think, it's more driven on future expected demand from their customers than it is on any level of inventory. So, I think it's the how much capacity do they have, how utilized is that capacity, what do they want to do with it?

And I think in cycles where there's too much capacity as we may have seen potentially built out among a number of our customers last year and their OEMs who were supplying equipment into that. What they've been seeing is a slowdown of new capital and new lines being deployed. But there's still opportunity for Cognex to improve the functionality of their lines.

And as I visit those customers as I have in the first quarter, sometimes I observe there's still a lot of manual stuff going on, manual inspection, which is when you consider often this is a clean environment, super clean environment, it's very costly to have human interaction there. So, certainly, there are still plenty of opportunities for Cognex, but I don't – we're definitely not going to see the new capital line build out for higher volume going on.

And I think the other thing we're probably seeing is the LED market. Some of the improvements that are going on in that space is making some of that technology perhaps a little more competitive, particularly of course on a cost basis and a performance basis. So, we're seeing some business with customers in that space looking a little brighter. But the actual dollars spent for those kind of technologies is much lower and the process is much less sophisticated than with OLED companies.

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Q

That makes sense. And then just in terms of quantifying the revenue base last year?

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

I'm not sure that's something we're going to be doing. No.

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Q

Okay. All right, thank you.

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Thank you.

Operator: Our next question is with Paul Coster with JPMorgan. Please proceed with your question.

Paul J. Chung

Analyst, JPMorgan Securities LLC

Q

Hi. This is Paul Chung on for Coster. Thanks for taking my question. So, just to follow-up on your regional breakout of revenues, seems like you're gaining share in Europe and the Americas, with growth rates above your main competitor, though it kind of seems light in Greater China and other Asia segments. So, are you seeing increasing competition in the Asian markets? I know you mentioned some Chinese competitors entering the mix, so anything you can mention there will be helpful. Thank you.

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

A

Yeah. Thanks for your question, Paul. I think – I would – I think we're seeing broad-based growth across our business. And what's really distorting that as you try to look through the regional growth rate is the consumer

electronics picture. So, one of our region where we're seeing very strong growth overall is the other Asia space, which includes Korea, ASEAN, India and Japan. And the base business there is growing very well, but you will see a significant reported decline and that's very much driven by this consumer electronics dynamic that we're talking about.

Elsewhere, we saw a very strong growth in America in the first quarter and that's probably due to the investments we've made there and our sales force over the last few years, the [ph] competitiveness (00:52:21) our technology and some pretty good macro effect going on in the market in general with the tax cuts and incentives to sustain capital and automotive investment going on. So, I'd say that's driving that.

Europe, similar but less so, I guess, I would say to those other markets. My own view is we're holding or gaining share in all those markets if you exclude consumer electronics. We've had bigger exposure. It's really due to the very sophisticated and intimate relationships we've had with five or so, half a dozen or so really sophisticated players that drove a lot of growth last year that we're going to see less of this year.

But I would say on that and I think our listeners will be interested, is I don't see us losing account share at any of those businesses. So, I really view this is a market phenomenon. It's not like we're suddenly on the out at any of these places, and I think those companies view our willingness to stay with them, to keep investing into their longer term plans as key. And one of the benefits we have to offer where perhaps some of our financially or less well-managed competitors might not be willing to stay the course. So, I'm not deterred by that at all, although obviously, the growth in the back three quarters of this year is not what we wish it was as the result.

Paul J. Chung
Analyst, JPMorgan Securities LLC

Appreciate it. Thank you very much.

Operator: Our next question is with Joe Giordano with Cowen & Company. Please proceed with your question.

Joseph Giordano
Analyst, Cowen & Co. LLC

Hi, guys. Thanks for the follow-up. When you go to like trade shows and things on the vision space, did you see a lot of these pop-ups that are entering? Some big, some larger, some smaller, but generally in the applications that don't have onboard intelligence and need the third-party software to run them. So, like what would need to happen for those types of products or applications to like compete in more for us versus what Cognex and KEYENCE are able to supply and – or why won't that happen long-term? Like what's your – what's the defense mechanism against those kind of competitors?

Robert J. Willett
President, Chief Executive Officer & Executive Director, Cognex Corp.

Yeah. Hi, Joe. Well, I would say in general, our industry has – it's been a situation -- it's been a dynamic where more technology is driving more growth, particularly at the high end of the market where there's so much that advanced manufacturers want to do with machine vision technology and so much cost that exists, whether it's around quality or labor or even the ability to make the things they want to make. But that's where we see huge growth.

Inevitably, our business is kind of growing in those applications and then we shed kind of lower value applications as they get less important or less kind of cutting-edge over time. And then I would say other customers – other

companies at the lower end of the market are adding intelligence onto their businesses over time. So, I think that's the dynamic we see. I could speak to something specific if you had that in mind, but I would say overall, that's what we see.

Joseph Giordano
Analyst, Cowen & Co. LLC

Q

Thanks.

Operator: Our next question is with Karen Lu (sic) [Karen Lau] (00:55:49) with Deutsche Bank. Please proceed with your question.

Karen K. Lau
Analyst, Deutsche Bank Securities, Inc.

Q

Hi. Thanks for taking my follow-up. I was just wondering if you can comment on any impact on sanctions on tariffs. I know you don't supply much to like telco equipment for some of those guys who make smartphones as well. So, I was wondering if you see any impact. And also on the tariffs front, I know you have some contract manufacturings from Asia. So, do you expect any impact to the extent that maybe you're buying components from China?

John J. Curran
Chief Financial Officer & Executive Vice President-Finance & Administration, Cognex Corp.

A

We're not expecting any real impact from tariffs on our business. Majority of our activity in Asia is sourced out of our plant in Europe, our plant in Ireland, and our inbound supply chain is not heavily exposed to China.

Karen K. Lau
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. And then the sanctions piece with some of the telco equipments players that also make smartphones, is there any impact there?

John J. Curran
Chief Financial Officer & Executive Vice President-Finance & Administration, Cognex Corp.

A

No. We don't expect any impact on that front.

Karen K. Lau
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. That's good. Thank you.

Operator: Our next question is with Richard Eastman with Robert W. Baird. Please proceed with your question.

Richard Eastman
Managing Director, Robert W. Baird & Co., Inc.

Q

I will go really quickly. Thank you, again. Just a quick question, John, when you talk about OpEx being flat sequentially, is it anticipated in that guide that options expense declines because R&D, SG&A, we have more head count, our sales will be up, so commissions, I presume, would be up. And I'm interpreting the sequential to mean in dollars. So, is the offset there that options expense declines from Q1 to Q2?

John J. Curran

Chief Financial Officer & Executive Vice President-Finance & Administration, Cognex Corp.

Yeah. There is some pickup on option expense from Q1 to Q2; a reduction in expense from Q1 to Q2.

Richard Eastman

Managing Director, Robert W. Baird & Co., Inc.

Okay. All right, that's the offset. And then very quickly, Rob, in the OLED market as that business unfolded for you last year and was very good, presumably your traction early in the year was in the Korean market. I'm curious towards the back half of the year, did you have any success penetrating the Chinese market for OLED manufacturing as it was built out through last year? Just kind of a share battle between the Koreans and the Chinese on the OLED capacity. And I'm curious if the exposure – your exposure today, Cognex exposure, includes the Chinese manufacturers.

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

Yes. So, Rick, certainly as you can see – I think if you [ph] peel it apart, (00:58:55) we did have very significant success with the Korean players in that space. But in addition, we had success with Japanese machine builders who are building OEM equipment that are being used and also some penetration of Chinese players as well, less significant. But we think we're well-positioned with all of those players.

Richard Eastman

Managing Director, Robert W. Baird & Co., Inc.

Okay. Understood. Okay. Thank you.

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

Thank you.

Operator: Our next question is with Bobby Eubank with Chevy Chase Trust. Please proceed with your question.

Bobby Eubank

Analyst, Chevy Chase Trust

Good afternoon, guys. Rob, can you talk about healthcare and some of the ex-logistics and 3D markets; consumer products and food products? Those markets are a little bit smaller for you, but can you maybe paint the opportunity in those picture, in those markets longer term? Thanks.

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

Yeah. Thanks, Bobby. And so, I think it's a fair statement to say about Cognex that we talk about big markets. We talk about automotive, consumer electronics, logistics, semiconductor and those are really very sophisticated users of our technology. But what's going on over time also is our technology is becoming less expensive, easier to use, and integrated and program and hence, being adopted by a lot more industries. And that's a nice dynamic that we have going on. It's part of what is driving the kind of growth rates that you see, that we've reported today in Q1 despite the downturn in consumer electronics.

So, as I look across our markets in the first quarter and I look year-on-year, we're seeing growth rates in excess – well in excess of 20% in markets including consumer products, including life sciences, medical devices, things like product security.

So, these are kind of, I would say, smaller, newer adopters of machine vision, but are really seeing a lot of growth for us. So, that's – and that's another reason why we really have needed to and have been successful in expanding our sales force so we can call on those customers.

Bobby Eubank

Analyst, Chevy Chase Trust

Q

I appreciate that. And, John, if you could quickly just mention the buyback stepped into Q1, a little bit higher than you've been running. And then just – given the share price decline, it seems like you're still very optimistic about the long-term opportunity in the market, putting some cash to work with the buyback. Thanks and have a great week.

A

Yeah.

John J. Curran

Chief Financial Officer & Executive Vice President-Finance & Administration, Cognex Corp.

A

Yeah. Sure, Bobby. So, yes, we were active in the market in Q1. Bought back just under 1.3 million shares for about \$69 million. We still have about \$126 million available to us to continue our buyback and we do expect to be in the market in Q2.

Operator: We have reached the end of the call and I would like to turn the call back over to Rob Willett for closing remarks.

Robert J. Willett

President, Chief Executive Officer & Executive Director, Cognex Corp.

Thank you. And thank you for joining us this evening. We look forward to speaking with you next quarter. Good night.

Operator: This concludes tonight's teleconference. You may disconnect your lines at this time. Thank you for your participation.

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