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## Q1 2018 II-VI Inc Earnings Call

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## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and welcome to the II-VI Fiscal Year 2018 First Quarter Conference Call. At this time, all participants are in listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time. (Operator Instructions) As a reminder, this call is being recorded.

I would now like to turn the call over to Mary Jane Raymond, Chief Financial Officer. You may begin.

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**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

Thank you, Michelle, and good morning. I'm Mary Jane Raymond, the Chief Financial Officer here at II-VI Incorporated. Welcome to our First Quarter Earnings Call for Fiscal Year 2018. With me today on the call are Dr. Chuck Mattera, our President and Chief Executive Officer; Dr. Giovanni Barbarossa, our Chief Technology Officer and the President of the Laser Solutions Segment and Gary Kapusta, our Chief Operating Officer. This call is recorded on Tuesday, October 31, 2017.

Just a few reminders for today. Our company has been a designing partner for our customers for over 40 years. We have earned that position with many customers by the quality of our designs and collaboration and by our commitment to honor confidentiality obligations.

Consistent with our [best] practice, we intend to keep our customer's confidential information confidential. We will not be giving information on this call about customers, designs, applications or future products except as permitted or as required by the disclosure regulations.

Secondly, any forward- looking statements we may make today during this teleconference are given in the context of today only. We do not undertake any obligation to update these statements to reflect events subsequent to today.

With that, let me turn it over to Dr. Chuck Mattera. Chuck?

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**Vincent D. Mattera** ***II-VI Incorporated - President, CEO & Director***

Thank you Mary Jane, and thanks to everyone for joining us. Before we get into our report, I'd like to thank the employees at our Santa Rosa, California and Port Richey, Florida facilities, who rose to the occasion in the face of substantial challenges from the devastating storms and fires that affected the country during the quarter. Thanks in large measure to their determination and dedication, any impact to our business was mitigated. I also commend the leaders of the relevant businesses for their extensive efforts in caring for the needs of our affected employees.

Now turning to our results. Fiscal year 2018 got off to a great start with first quarter revenue of $262 million, 18% over Q1 FY '17. It was just 4% lower sequentially with minimal effects of the typical Q1 seasonality. Our year-over-year growth was 15.5% organic and 2.5% from acquired companies. We maintained our solid backlog and we experienced double-digit revenue growth in all three segments as compared to last year. From a major market perspective, the communications end market revenue grew 13%, the industrial and semiconductor capital equipment end-market grew 12%, and the military end-market grew 16%. In addition, all of our new markets demonstrated sequential growth, including VCSELs for consumer and automotive electronics, optics and ceramics for EUV lithography tools, fiber laser components and silicon carbide substrates.

The integrations of our 2 new acquisitions, namely IPI or Integrated Photonics into the Photonics segment and the U.K. fab, now called the Compound Semiconductor division into the Laser Solutions segment are on track. Immediately after the acquisition, IPI begin contributing stronger revenue and earnings than compared to our internal plan, and actually exceeded its Q1 forecast. In addition, with the positive customer input on the growing market opportunity, we promptly began adding new capacity to meet the increasing demand in backlog.

Turning now to our core businesses. The industrial and semiconductor capital equipment markets continued on a growth trajectory and accounted for $104 million of our revenue. In fact, we experienced sustained demand in all regions of the world. In China, we continue to see a trend of increasing amounts of backward integration by many laser tool manufacturers, who are beginning to make their own laser engines. That trend is driving demand for our differentiated laser and optics components portfolio of products. Demand was also broadly distributed by end-markets.

Revenue in nearly all product lines grew in the first quarter over Q1 of FY '17. Orders and revenue for EUV applications more than doubled compared to the same period last year. The CVD Diamond and CO2 laser optics production lines in Saxonburg have been driven to full capacity by this surging demand in EUV. In order to quickly expand our production lines, we will soon be relocating about 100 staff employees to a new office space near Saxonburg.

Some recent industry reports put the combined backlog and production outlook for EUV tools to be close to $6 billion. We estimate that the value of our content to be about 1% to 2% of the machines' selling price. Needless to say, we are very excited about the growth of this product line over the next 1 to 3 years.

The communications market continued to be stable for us with $109 million in revenue in the quarter. Revenues from the communications market grew 13% overall compared to Q1 FY '17 and remain steady sequentially. We continue to see the benefits of our longer-term agreements built on deep customer intimacy and our ability to quickly add capacity and evolve our product portfolio to new markets and applications.

Our shipments in Q1 continue with no evidence of double bookings or de-bookings. In fact, in some cases, some customers have requested and continue to push for earlier delivery dates resulting in our Q2 order coverage being among the highest levels we've seen.

Silicon carbide substrates sales activity increased again. Revenues grew more than 35% over Q1 FY '17 and there continue to be increased numbers of customer engagements. Silicon carbide substrates for wireless base stations are now in demand for growth outside of China and an increasing percentage of our increase are from power device customers, who are now requiring 100 and 50 millimeter substrates instead of 100 millimeter substrates, as the overall end-market demand increases.

As we indicated last quarter, we believe that the substrate TAM is forecasted to be about $300 million over the next 5 years and so we are investing to maintain our advantage and leadership position. We expect to continue to be a leader in this fast growing market, especially as we install new capacity and introduce manufacturing innovations to improve yield and throughput and manufacturing costs.

With that, I'd like to turn the call over to Dr. Giovanni Barbarossa to highlight some of the activities and successes of our increased R&D investments and a few examples of our technology and product programs. Giovanni?

**Giovanni Barbarossa** *II-VI Incorporated - CTO & VP of II-VI Laser Solutions*

Thank you, Chuck. We are glad to report that in Q1, we begun deliveries of qualified products from our vertical integrated 6-inch VCSEL platform, as expected, and well on track, with our manufacturing game plan. I would like to thank our Optoelectronics group for their hard work and achievements to become qualified on the very tight 15-month timeline.

In such a challenging timeline. our team integrated two acquisitions, expanded the manufacturing capacity with new tools and transferred developed integrated and qualified new equipment and processes required for the manufacturing of VCSELs for 3D sensing and other optoelectronics devices on 6-inch wafers, a major switch from our legacy 3-inch platform.

During this time, we continue to engage with several customers and developed new products to meet the specific requirements. We expect output from these operations to accelerate during the remainder of our fiscal year, and we expect the Optoelectronics group to be a valuable contributor to our sequential growth during the second quarter. We will continue to invest to scale our vertical integrated operations. Since in our opinion, VCSEL technology and 3D sensing applications are both still very early in terms of product development and market adoption.

We can see this from many active customer engagements that we have underway and are participating in the broad consumer electronics and automotive markets. We are also really excited about the first phase of investments that we're making at our compound semiconductor division. The recently acquired Epi and wafer fab in the United Kingdom. We believe that we are well positioned in the compound semiconductor materials and device market, with the emergence of several megatrends, such as Industry 4.0, the Internet of Things, 3D sensing, autonomous vehicles, power electronics for the rapidly developing electric vehicle ecosystem and the promise of increased connectivity to 5G radio frequency and optical backhaul and front-haul networks.

These are all excellent strategic fits with our existing core competencies and differentiated advantages to our customers. As a result, we believe we are building momentum; with increasingly larger accounts, we are transforming the markets.

Turning now to our new products in our major core markets. In the industrial materials processing market, we built on the momentum that we generated in June, when we demonstrated a new seam tracking technology integrated with our remote laser welding heads at the LASER World of PHOTONICS show in Munich. The seam tracking feature is ideal for hinge assemblies, such as car doors, hoods and trunks. Our automotive customers, some of the leading brands for North America and Germany are currently working with us to introduce our seam tracking capability into their production lines.

In the military market, we leveraged our highly reliable gallium arsenide laser technology to develop 200 watt actively cooled laser bars and multi-kilowatt stacks for new directed energy weapons. These products were developed under a military program and formally launched in September at the Directed Energy Systems Symposium in Monterey, California.

These laser bars and stacks are uniquely differentiated in their ability to operate at extremely low temperature conditions, such as those experienced by airborne vehicles. In the optical communication market, we announced in September our new flexible structured optical module platform for EDFAs or erbium-doped fiber amplifiers at the 2017 European Conference on Optical Communication.

This product is a breakthrough in enabling high performance optical amplifiers to be custom fit to the narrow spaces within coherent transceiver modules. They continue to be designed into smaller and smaller form factors. Such a product has received broad interest by the major manufacturer of coherent transceivers, transponders and line cards and we are already ramping up production. This should position us well for the anticipated strong demand for 100, 200 and 400G in major applications worldwide, particularly in China and North America. It is also an ideal technology for the next-generation coherent transceivers, designed to operate beyond 1 terabit per seconds. In the data center interconnect market, we expanded our product portfolio with the introduction of our Optical Line Subsystem that was demonstrated at the same conference together with Inphi's 100G PAM4 based transceivers. The combined capability offers cloud service providers and enterprise customers a direct-detection DWDM solution with a combined transmission rate of up to 4 terabits per second over a 20-kilometers reach for campus and datacenter interconnect applications.

Such a solution will significantly lower cost than incumbent coherent solutions of grey optics solutions in fiber exhaust situations. In the intra-datacenter interconnect market, our sales of VCSELs and HCSELs grew about 75% year-over-year. Sales of our miniature Z-block precision assembly mux/demux experienced a 34% growth, driven by the demand for land DWDM and CWDM intra-datacenter transceivers, as well as client transceivers both in CFP and QSFP form factors.

Our Z-block mux/demux is based on our thin-film-filter technology demand for land DWDM and CWDM intra-datacenter transceivers as well as client transceivers, both in CFP and QSFP form factors. Our Z-block mux/demux is based on our thin-film-filter technology, the leverages of our recent investments in manufacturing capacity.

With that, I would like to turn the call over to Mary Jane, who will provide the details of our first quarter results and Q2 FY '18 guidance. Mary Jane?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

Thanks, Giovanni, and hello to everyone on the call. Regarding our Q1 reported financial results, just as a reminder, on the second page of the press release, we show the segment results. This page details by segments the book-to-bill ratio, the revenue, operating income and the operating income margin.

The distribution of our Q1 revenue by end market was 42% in communications, including wireless, optical and data communications, 40% in industrial and semiconductor capital equipment and 10% in military. Our Q1 sales were geographically distributed 45% in North America, 23% in Europe, 19% in China, 7% in Japan and 6% for the rest of the world.

China remained a strong market for us in the first quarter from both an industrial and communications perspective.

The company's overall gross margin for Q1 was 40.5% and exceeded the fourth quarter gross margin due to increasing shipments of our new investments, and a one-time inventory valuation of about 100 basis points in one product line. The operating margin for this quarter was 11.4%, expanding 70 basis points compared to 10.7% for Q1 of FY '17, inclusive on our recent investments. The EBITDA margin was 18.9% for this quarter compared to 18.1% for Q1 of FY '17.

The acquisitions of IPI and the U.K. fab contributed $6 million of revenue combined in the quarter and were dilutive by $0.06 inclusive of the amortization of the inventory step-up, that is typically amortized within the first 2 quarters after an acquisition. The IPI acquisition was integrated into the Photonics segment and the U.K. fab has been integrated into the Laser Solutions segment.

With respect to the segment operating margins, the inclusions of the U.K. fab acquired in August in the Laser Solutions segment, drove a lower operating margin for that segment; the one-time cost of deal fees and the inventory step-up account for 220 basis points and the operating dilution accounts for 300 basis points. (inaudible), the Laser Solutions margin is consistent with the sequentially prior quarter's margin of 8.7% in Q4 FY '17.

As for the Photonics operating margin, it was higher than the historical margin level and included some one-time inventory valuation adjustments, affecting the margin by about 250 basis points. We finished the quarter with $390 million in backlog, down only $9 million from Q4, and 26% higher than Q1 of FY '17. This consists of $135 million in Photonics, $145 million in Performance Products and $110 million in Laser Solutions.

The backlog contains orders that will shift over the next 12 months. The backlog in Photonics decreased as we expected just as the lower book-to-bill ratio was as we expected. [Actually] Q4, FY '17, our Photonics backlog had grown 40% in a year, and we expected to ship off that backlog in Q1. Even now, our Photonics backlog is 18% higher than Q4 of FY '16.

We had $6.3 million in share-based compensation for Q1, an increase of 77% over the Q4 expense of $3.5 million, due to the share price for the new FY '18 equity grant approved in late August. We expect the annual expense for share-based compensation to be about $20 million for FY '18.

Some of you have asked us to break out the amortization from the D&A total, since all of our amortization is acquired. This is the amortization of acquired intangible assets. Amortization in Q1 was $3.6 million. Generally speaking, amortization is about 20% of the D&A total. The company had other income of $700,000, primarily from favorable currency gains with a smaller amount from equity earnings.

The total capital expenditures this quarter were $37 million. The Q1 FY '18 tax rate was 28.5% and we expect the ratio for this year to be between 18% and 21%.

The reported EPS in the quarter was $0.32 per share, and $0.35 without the one-time acquisition effect. This compares to $0.26 a share in Q1

FY '17 on a reported basis. Just to correct, our tax rate in the quarter was 21.5% and we expect the rate to still be 18% to 21% for this year.

Our cash, $241 million, and our net debt position is $230 million. We completed our convertible debt offering for $345 million with a 33.5% conversion premium and a 25 basis point coupon to diversify our sources of liquidity. We used $50 million for a specially authorized one-time simultaneous share repurchase. We expect the proceeds from the convert to be used for our investment programs as those needs and opportunities arise.

In the meantime, we paid down $252 million of our higher interest rate debt on the revolver. Our revolver now has $40 million outstanding and the term loan is at $80 million at quarter end, the quarter ended 9/30, and is $75 million outstanding now.

Interest and debt amortization expense in the quarter was $3.6 million compared to $1.2 million in Q1 of FY '17 when we had no amortization for instruments like the convert -- for no amortization in the lower amounts drawn. So we had lower amounts drawn on the revolver at this time last year.

For Q1, [the straight] interest was $2.6 million and the amortization for the convert discount and cost was $1.1 million. Going forward at this debt level on a quarterly basis, the total interest expense will be about $5 million with cash interest being about $1 million and non-cash amortization about $4 million.

We will determine the final method to account for the convert, but for the convert offering, during this current quarter, the Q2 quarter of FY '18.

Turning to the outlook. The outlook for the second fiscal quarter ending December 31, 2017, is a revenue of $272 million to $282 million and GAAP diluted earnings per share of $0.35 to $0.38. The EPS range contains $0.06 of total interest and amortization expense for our existing debt, $0.05 of which is non-cash or about $0.02 greater than Q1 FY '18 and $0.04 greater than Q1 FY '17. The EPS range also include $0.45 operating dilution for the net of our recent acquisitions. The diluted share count is now 65,283,000 shares.

For comparison for last quarter, the results for the second quarter ended December 31, 2016 were revenues of $232 million and GAAP diluted earnings per share of $0.37. Remember, the Q2 FY '18 EPS included $0.04 of positive one-time items, including a $5.5 million positive foreign currency gain offset by inventory and earn-out valuation increases.

For more information on our company, II-VI will hold its first ever Investor Day at the NASDAQ market site in Times Square, New York City next Wednesday, November 8, 2017. The webcast will begin at 9:30 in the morning. For those of you who wish to join on site, registration is required for security reasons and we ask registered guests to please arrive by 9 o'clock in the morning. We hope you can join us.

Now, as we turn to the Q&A for this call, remember that our actual results may differ from these forecasts due to a whole variety of factors. Those include but are not limited to product mix, customer orders, competition and general economic conditions. I will also remind you that our answers to your questions today may contain certain forward-looking statements, which are based on our best knowledge today, and forward actual results may differ materially.

In addition, during our Q&A, we will abide by our obligations to protect our customers' confidential information and as a result, we may only answer your questions to the extent allowable. Michelle, you may open the line for questions.

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**Operator**

(Operator Instructions) Our first question comes from Dave Kang of B. Riley. Your line is open.

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**Dave Ku Kang** ***B. Riley & Co., LLC, Research Division - Senior Analyst of Optical Components***

I guess first question is on the VCSEL, can you give us what the revenue was, orders and how should we -- what should we expect for second quarter?

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**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

With respect to the first quarter, we don't give revenue by product line. So we won't answer that. And as we indicated in the script, we do expect to see VCSELs being a good part of our growth in the second quarter.

**Dave Ku Kang** ***B. Riley & Co., LLC, Research Division - Senior Analyst of Optical Components***

So nothing material included in the outlook, is that a fair assumption?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

I didn't say that. We don't forecast by product line.

**Dave Ku Kang** ***B. Riley & Co., LLC, Research Division - Senior Analyst of Optical Components***

Okay. What about on the optical communications side, book-to-bill was 0.78%, do you believe this is really the bottom here? Any color on China as well as on North America?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

So, at this point, I think as we said, China continues to be a good market for us in optical, but as well as in industrial as is North America. We look forward to having a very good year in optical. Whether or not, this is precisely the bottom or not, I guess I can't precisely say since we don't forecast the book-to-bill. But generally speaking, we expect to have optical see growth, the optical communications side see growth this year.

**Dave Ku Kang** ***B. Riley & Co., LLC, Research Division - Senior Analyst of Optical Components***

What about this quarter, can you just go over your outlook assumptions for second quarter then by segments, if possible?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

We don't forecast by segment. I mean, I would expect to say, as I said, we expect for the year to have communications growing in this year. That's probably the extent that we can say, since we really don't give guidance by segments.

**Dave Ku Kang** ***B. Riley & Co., LLC, Research Division - Senior Analyst of Optical Components***

Got it. What about in terms of gross margin and OpEx for your second quarter outlook?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

So first of all, I think with respect to the gross margin, we continue to focus everyday on improving the set of margins in the company starting first and foremost with the gross margin. I think as we continue to see our various growth markets continue to pick up speed, we will see positive contributions to the margin. So having the margin now at 40.5%, it's been a while since the company crossed 40%. So I don't know if it's necessarily going up by 100s of basis point sequentially, but we would look [for] for this year to continue to see what we can do to improve that margin. I think that's probably what we can say on the margin. With respect to OpEx, we do expect to continue to invest in our operations, particularly from an R&D point of view, and we'll will look to ensure that to the extent possible, we can reduce or monitor the SG&A to allow for the investments in aggregate in OpEx to be more funded in R&D than in G&A.

**Dave Ku Kang** ***B. Riley & Co., LLC, Research Division - Senior Analyst of Optical Components***

Okay. And then on the acquisitions IPI and Kaiam, obviously, they are having some impact in terms of dilution. When should we expect that to become at least neutral?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

So with respect the 2 acquisitions, obviously, we gave the numbers combined. IPI today is accretive to earnings. Most of the dilution due to the low levels of revenue were mostly with the fab. As we indicated last quarter, we will work through this year to try and minimize that impact on the margins as much as we can as the year progresses and the revenue picks up.

**Dave Ku Kang** ***B. Riley & Co., LLC, Research Division - Senior Analyst of Optical Components***

Okay. And lastly on the clarification, what do you say the number of shares for second quarter, what should we use for number of shares?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

Sure, it's 65,283,000.

**Operator**

Our next question comes from Mark Miller of the Benchmark Company.

**Mark S. Miller** ***The Benchmark Company, LLC, Research Division - Research Analyst***

Are you projecting broad-based growth in fiscal '18? I'm just wondering, in terms of actual sales numbers, if you could -- not giving the exact numbers are expected, of course, I don't expect that, but in terms of what areas do you think that the greatest sales growth will come in terms of dollar amounts?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

It could be all over the map. I mean, as we saw last year, we saw silicon carbide business double in the year, Giovanni has also just described here the excellent growth that we are still seeing in EUV, so because we don't forecast by segment, it's tough to tell. But I would say that I do not think any of us -- and Chuck will have a better answer, would expect to see any major end-markets dramatically down. That's not giving you a number by growth area, but I do think we would expect to see fairly broad-based growth in the FY '18 here.

**Vincent D. Mattera** ***II-VI Incorporated - President, CEO & Director***

Across all 3 segments.

**Mark S. Miller** ***The Benchmark Company, LLC, Research Division - Research Analyst***

I'm assuming that VCSELs included with (inaudible) and EUV?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

I'm sorry, I didn't mean not to mention that, it's just that was having a better record quarter [quarter to] last year. So how the growth goes is always a little bit hard to predict, which is the reason we don't give growth by segments. But as Chuck said, we would expect to see the growth contributed for the aggregate of the company, contributed by all three segments.

**Mark S. Miller** ***The Benchmark Company, LLC, Research Division - Research Analyst***

Another firm shipping into the 3D sensing market for VCSELs has projected that they expect the VCSEL margins to be above their corporate average, how do VCSEL margins look for you as you ramp through the year, are they going to be above average, at average or below?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

I'd say that first of all, we don't give gross margin and margins by product line either, but as a general matter, I think growth materials, materials and diodes tend to be generally better than margins -- than that of assemblies, let's say, which have a lot of assembled parts to them. As we've said, fairly consistently, we do not expect to see the VCSELs margin be dilutive.

**Mark S. Miller** ***The Benchmark Company, LLC, Research Division - Research Analyst***

Kaiam's book-to-bill has been down last 2 quarters, can you give a little more color on that?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

Sure. Well, first of all, everyone will remember that in the 12/31 ended quarter, which was second quarter of '17, we saw a fairly significant increase in the bookings as we secured longer-term agreements with customers. That then provided the orders that would normally have come in what would have been, say, 3 more months out or 6 more months out, and that is why we actually say, as I said, that we expected the bookings to go down. We continue to see fantastic customer interest across our product lines, including the more core product lines, not just the newer ones Giovanni described. So I think, again, we expect to see the communications market to be a growth barrier for us coming into -- for the 2018 year.

**Vincent D. Mattera** ***II-VI Incorporated - President, CEO & Director***

I would add, Mark, there were no surprises in that for us based on Mary Jane's very excellent explanation. There were no surprises. Just 2 weeks ago, [I]was in China visiting some large customers. I believe that as we go forward, that we will continue to see, as Mary Jane said, the opportunity for us to grow in that business.

**Mark S. Miller** ***The Benchmark Company, LLC, Research Division - Research Analyst***

And just 2 more questions. Could you remind me where the VCSEL orders would come in, are they laser solutions and in the Photonics segment -- and I'm sorry I missed the backlog break-up?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

Sure. So first of all the VCSEL sales are Laser Solutions and the way the backlog breaks out right now is first of all $390 million in total. So it's $135 million in Photonics, $145 million in Performance Products and $110 in Laser Solutions. And as I noted that level of a backlog for Photonics at $135 million is still 18% higher than it was in Q4 of FY '16.

**Mark S. Miller** ***The Benchmark Company, LLC, Research Division - Research Analyst***

And one more, wireless was roughly 40% of sales or 42%?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

Sorry. Say that question again, Mark.

**Mark S. Miller** ***The Benchmark Company, LLC, Research Division - Research Analyst***

Wireless sales were roughly what percent of total sales? Was it 42% or 40%?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

So sorry. So it's 42% for the totality of communications, which is wireless, optical and data.

**Operator**

Our next question comes from Jim Ricchiuti from Needham & Company.

**James Andrew Ricchiuti** ***Needham & Company, LLC, Research Division - Senior Analyst***

Just given the backlog and bookings trends in Photonics would you anticipate, and I know you don't forecast segments, but just in light of this, would you assume that the Photonics business would be flat in Q2 or up modestly?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

Well, as we said -- so thanks for admitting that we don't forecast by segment. I think it's tough to tell this early in the year how it will actually break down. As we said, we expect to see growth across the end market drivers.

**Gary Alan Kapusta** ***II-VI Incorporated - COO***

Jim, I would add a -- just a quick reminder that a double-digit percentage of our Photonics revenues are derived from selling into the fiber laser market, the life sciences market and the EUV optics market and in particular they continue to be operating at a very high level. So there is a -- we're not exactly sure, but just as Mary Jane said we may see a little bit of a trade-off back and forth between the industrial part of the business and the communications part. But as Mary Jane said, there will be a little bit of a balance between the 2. Okay?

**James Andrew Ricchiuti** ***Needham & Company, LLC, Research Division - Senior Analyst***

Okay. Going to your guidance for, what, 4% to 8% sequential revenue growth, if I heard you correctly saying, a fair amount of that sequential increase is going to come from the ramp-up in the VCSEL businesses. Is that correct? Did I understand that correctly?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

No.

**James Andrew Ricchiuti** ***Needham & Company, LLC, Research Division - Senior Analyst***

No?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

No. We expect to have a number of drivers driving the increase (technical difficulty) Q2. VCSEL will be a part of it.

**James Andrew Ricchiuti** ***Needham & Company, LLC, Research Division - Senior Analyst***

Okay. Looking at the range that you're giving for revenues for the fiscal second quarter, can you talk about what the biggest contributors might be to the range of revenues that you're guiding to?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

I think we would expect to continue to see increases in industrial, for example. The industrial end market is probably, generally speaking, the one that has [seen the lower pickup]. We already talked about the new products which would be across all of the new areas, VCSELs, EUV et cetera. And we we would expect to continue to see some decent strides. Whether it's a major contributor of the growth is, I think, we'll see on Photonics. But communications as a general matter, I think, will also be a contributor. So, it's tough to break down exactly how it's going to come forward.

**James Andrew Ricchiuti** ***Needham & Company, LLC, Research Division - Senior Analyst***

Okay. And then last question for me is just looking back at the quarter within the industrial business, you may have given this, I may have missed it, but can you say what -- talk a little bit about the performance of the CO2 business and the fiber-related business? It looks like you had a pretty good quarter in industrial. What were those 2 pieces in terms of whether you want to break it down by dollar amount or just increase?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

Sure. I mean, I'd say it this way. I mean, I think CO2 -- high power CO2 laser components and fiber laser components for higher power laser applications continue to be about 15% to 18% of the company overall. In fact, for CO2 we will be moving about 100 staff employees out of the Saxonburg locations to prepare for the expansion that they need to do, some from industrial, but also [free] so -- as we have expanded the Saxonburg plant in 10 years. So that's kind of the major big deal here. And then the balance of the laser -- the industrial market would be for optics and other components from the industrial market for EUV and then the balance for the precision optics that tends to be used in applications like laser marking and engraving, so once that are lower power CO2 applications.

**Gary Alan Kapusta** ***II-VI Incorporated - COO***

Yes. I would add that the momentum that we saw in particular in the fourth quarter and specifically in June, as it accelerated throughout the quarter, that momentum has carried for the CO2 laser optics business largely from Europe and the U.S. and maybe slowed down just a tad in Asia, relative to that momentum from the fourth quarter, Jim.

**Operator**

Our next question comes from Richard Shannon of Craig-Hallum.

**Richard Cutts Shannon** ***Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst***

Let me start with a couple of quick ones on 3D sensing. I think as you confirmed what you said last quarter, it looks like to be up into full production by the end of this current quarter. Can you talk to any degree of quantification or qualification about what kind of capacity you expect to have in place and also whether you expect the gross margins to be kind of a mature level exiting this quarter as well?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

Actually, no. So first of all, we are producing across our capacity and very, very happy as Giovanni explained with the excellent ramp-up that the team did. But first of all, methods improvement increases an output, yield improvement goes on in every (inaudible) every day. And the ability to do that continually will expand the capacity of the installed machine tools. We could see that very clearly last year as a different example in optical when we expanded quite a lot in the '16 to '17 year, even before we had a capacity. So that will continue. From a -- will the margins top out in one quarter, I mean we are very early in this game. This is hardly the first inning. I mean, it seems to me like it's almost a starting process for this end market, really developing on applications for 3D sensing adoption really coming into their own. I would expect that we would continue to work for increasing margin improvement as time goes on here.

**Richard Cutts Shannon** ***Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst***

Okay, fair enough. Second question on silicon carbide here. I guess the question I have is, as you move forward on getting larger sized substrates, I wonder if you could talk about the progression within the industry and your ability to gain share in addition to the strong capacity growth you have here, when we might see that? And kind of the secondary question on this topic, Chuck, if you can characterize this, what's -- could you give us a sense of the scale of your silicon carbide business today?

**Vincent D. Mattera** ***II-VI Incorporated - President, CEO & Director***

Okay. Maybe I'll take the second one first and I'll ask Gary Kapusta, our Chief Operating Officer, to make some comments about the rate at which we're expanding our operations. I believe that we have at least the largest independent infrastructure in place today for producing high quality semi insulating and conducting larger diameter wafers for this market. And we've given some indication, Richard, of both the size of the market, we've given an indication of the size of our business. So you can triangulate roughly where we are relative to the marketplace. I think what matters the most right now, as I just -- I just finished traveling between Europe, U.S. and Asia, every place I go, there is a customer that would like to buy more from us and more of what we can make. And so we have, and Gary can talk about it just for a minute, we have one of our major capital expansion investment projects to being inside this business, because we believe that our technology and our products are not only scalable, but they are of such high quality that long term they are going to be in demand, even as others bring on additional capacity. So I feel very excited about it and disappointed that we cannot serve everybody as much as they want to here at the moment. But I believe that that situation is going to come more into balance here inside the next 2 to 4 quarters. Gary, what would you like to add?

**Gary Alan Kapusta** ***II-VI Incorporated - COO***

Yes, thank you Chuck. And I appreciate the question, Richard. And good morning everyone on the call. Yes, absolutely silicon carbide is a very exciting technology for us. What I would say is its time has come. We have prepared for it in terms of the technology. We continue to get very, very good feedback from our customers, relative to the quality of our products. What we need to do is, continue to work to expand our operations to address this ever increasing market. And we're doing that and we're doing it at a pace that's very, very comfortable for us [where we control for us] in line with our customers' expectations. So we're working with our customers to understand their long-term requirements to make sure we've got the right level of agreements in place. So as we add capacity, we're doing it in a manner that's consistent with their needs as well as with a level that we are comfortable with. So we've basically now got ourselves in a position where we expanded capacity, probably almost doubling from where we were a few quarters ago and we'll continue to add capacity as it makes sense on a go-forward basis.

## QUESTIONS AND ANSWERS

**Vincent D. Mattera** ***II-VI Incorporated - President, CEO & Director***

Yes. Thanks, Gary.

**Richard Cutts Shannon** ***Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst***

Okay, that's helpful, thank you for that Gary. One last question for me, I'll jump out of the queue on operating expenses. And I'll admit I may not have captured all or some of the moving parts here, especially related to the acquisition stuff. But the OpEx appears to be a bit higher than what I was anticipating. I think that's kind of extending into the December quarter. Mary Jane, I wonder if you can give us a sense overall here of when we expect to see some leverage coming from the OpEx, understanding obviously you're investing in some very high-growth markets. But when can we start to see some of that leverage to occur?

**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

Well, I'd say that it's an important goal for this year for us to moderate the -- typically the G&A growth. I think as we do that some of it may move to engineering, honestly and some of that, we would hope to have as part of our, as we said earlier, our ongoing margin improvement. But as we just indicated [through a dial-in], we have a U.K. acquisition in the quarter's results, which we didn't have last time as well as some of the deal costs.

**Operator**

Our next question comes from Tim Savageaux of Northland Capital.

**Timothy Paul Savageaux** *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

I want to follow up on Chuck's comment on, I don't know if it was specifically on communications. Well, I guess maybe it was with regard to a recent trip to China and just ask you to maybe amplify on that a little bit. We've had a milestone recently with the Communist Party Congress over there. It sounds like you may have been over there right at that time. And at least maybe some indications early of increased activity after what's been a pretty quiet '17 although the impact on you guys has been, I would say, a little more muted than most although I think we do see some of that in the book to bill. In your commentary talking about coming back with a sense of growth potential for the year, are you meaning to imply that there that you're seeing some sort of uptick or increase in activity in China either in the near to medium term, that will be -- on the optical comp side? That would be my first question.

**Vincent D. Mattera** *II-VI Incorporated - President, CEO & Director*

Thanks for your question, Tim. Tim, there is really 2 simple and straightforward -- there is only just 2 components to my answer. One, we were not surprised in the first quarter by our results. Given the negotiation that we did inside our FY '17, we weren't surprised. That's number 1. Number 2, I would not like to have you think I am speaking broadly about the market or my view about it. But I am liking for you to hear what I have to say and I appreciate your question. I got a strong sense that our key customers in China value what we're doing. They value the infrastructure we have in our product portfolio. And my sense is that independent of how much the demand is going to grow and when that we will play a valuable -- continue to play valuable position in their supply chain and I'm pleased to report that.

**Timothy Paul Savageaux** *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Okay. And maybe if I could follow up, still on the communications side, at least in the last couple of quarters, you've given some detail with regard to various end market breakdowns within the communications space. I don't think I heard that this time. But if you -- I wonder if you could sort of talk to trends, whether they'd be across metro long-haul, ROADM or intra or inter data center with regard to either revenues or bookings, anything kind of notable there from what we've seen recently?

**Vincent D. Mattera** *II-VI Incorporated - President, CEO & Director*

Well, Tim, I will ask Mary Jane, just to make a short summary comment. But I think Giovanni's comment about the VCSEL growth and the VCSEL business quarter -- year-over-year for the first quarter was a -- was one of the highlights of the quarter for our communications business. Yes. Do you want to add to that, Giovanni?

**Giovanni Barbarossa** *II-VI Incorporated - CTO & VP of II-VI Laser Solutions*

Yes, just with -- hey, Tim, this is Giovanni here. So obviously you know the market is not growing at 75% a year. I mean that's not -- and so clearly, you can expect that we have some significant market share gain for that product line, despite the fact that actually our platform is limited to in terms of temperature, performance and so far. So we have a something working to address that limitation. So we expect to further expand our market presence in that market. So I think we are very pleased by this 75% year-over-year growth, which is I believe it's outstanding compared to the market rate.

**Mary Jane Raymond** *II-VI Incorporated - CFO, Treasurer & Assistant Secretary*

Just to give you a little bit on the numbers. Roughly speaking, Tim, they're relatively the same as last quarter with the exception, as Giovanni just said, in Datacom where it was 17% of the make-up in the quarter compared to 13% in Q4.

**Timothy Paul Savageaux** *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Okay. So that comment was on VCSEL growth into Datacom applications, which we wouldn't, given the distances, assume would be focused inside the data center. Sorry, I missed that one.

**Vincent D. Mattera** *II-VI Incorporated - President, CEO & Director*

Go ahead.

**Timothy Paul Savageaux** ***Northland Capital Markets, Research Division - MD & Senior Research Analyst***

[Do you have color]? And last question for me and this is really focused on -- you had mentioned a revenue contribution from recent acquisitions in the quarter. I think you'll have -- I think that was sort of a full quarter of IPI. I don't know. I guess the question is is there any further kind of one-time revenue contribution contemplated in the Q2 guidance. I assume it would to be pretty minimal, if that were the case. And if you could run through just really quickly, the dilution metrics for those deals for Q1 and Q2 forecast again? I think I missed some of the details there.

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**Mary Jane Raymond** ***II-VI Incorporated - CFO, Treasurer & Assistant Secretary***

Right. So, first of all the revenue we should expect, I think if this is what you just said, that the revenue is not going to change materially from the first quarter going into the second quarter, so that's the first part. Second of all, the way the dilution accretion works, so IPI is actually accretive. So it's accretive by about -- will be accretive by about -- at least the balance of that, of the dilution is more than U.K. fab.

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**Timothy Paul Savageaux** ***Northland Capital Markets, Research Division - MD & Senior Research Analyst***

And well, maybe I'll sneak one more question here. While we're on the U.K. fab and maybe this sort of relates to questions about capacity as well. When you announced that, you talked about and I wouldn't infer there is anything there related to the Datacom strength that you just mentioned that would be your kind of core business. But what sort of expectations do you have there for revenue coming out of that new facility? Whether it's Datacom transceiver focused perhaps with Kaiam? Any update on how that agreement that was referenced in the acquisition announcement has evolved? And then I guess can you say, is that facility -- what's the timeline there for that facility to be prepared up and running from a [VCSEL ray] standpoint assuming you're focused on adding capacity there as well?

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**Vincent D. Mattera** ***II-VI Incorporated - President, CEO & Director***

Okay. Let me -- Tim, this is Chuck. Tim, thanks for your question. As we indicated at the time of the acquisition and during last call, first of all, it's a great facility and it's a plug and play facility. It's got a revenue, it's got a suite of 20 different products that we can make there for gallium arsenide RF market, and we're focused on keeping the line more and running through those commercial products that we have. But more importantly we are planning and we are already beginning to execute a multipurpose compound semiconductor device fab plant. Having said that over the course of the rest of this fiscal year, we will continue to invest both in R&D and in capital to outline and lay out that facility, not for in-year revenue and -- or large in-year revenue and profit benefit, but for the years beginning next year to come. So it will take us -- Giovanni just kept on telling it, it took us 15 months to get this into place in the optoelectronic group. Our target would be to do it a little bit faster and do it might be VCSELs to the extent that we're going to expand our VCSEL array production capacity in the U.K. as well as the development of indium phosphide based semiconductor devices. Those are the 2 tracks that we are on in addition to sustaining the growth in the gallium arsenide RF market. And in each case they do require us to think and invest both in equipment and in technology and in qualification and we've laid out a fairly nice plan to be able to do that as part of our work plan for this fiscal year '18. And the capacity that will come online, I believe will come online -- begin to come online in a meaningful way in the next fiscal year '19.

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**Timothy Paul Savageaux** ***Northland Capital Markets, Research Division - MD & Senior Research Analyst***

Got it.

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**Gary Alan Kapusta** ***II-VI Incorporated - COO***

I do want to come back to 1 other point, if there was a question about our VCSEL ramp and our acceleration in the ramp in the second quarter. I do want to just point out because we said in our prepared comments about the growth implied by our second quarter guidance over the first quarter that have a meaningful or a valuable component of it from 3D sensing VCSELs in it. And I just want to make sure we reiterate that.

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**Vincent D. Mattera** ***II-VI Incorporated - President, CEO & Director***

I think we have time for -- are there more questions in the queue?

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**Operator**

There are no further questions. I'd like to turn the call back over to Chuck Mattera for any closing remark.

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**Vincent D. Mattera** ***II-VI Incorporated - President, CEO & Director***

Okay. I'd like to make some summary remarks. I believe the transformative and value changing forces are accelerating in our markets. I'm excited about the future and the great people at II-VI who are helping me to lead the next reinvention of this great company. Together, we are positioning II-VI to participate in the next generation of information and communication networks, the advent of autonomous driving and sensing networks and the anticipated transitions in electric vehicle market among others. These changes are being enabled by the rapid adoption of new technologies in emerging growth markets focused also on such transformative applications as virtual reality, augmented reality, machine learning, artificial intelligence that new infrastructure is expected to enable. And so -- and as much as these are core to a whole new economy in the making, they are also core to our ambitious strategy. As we get ready to enable the evolution of the convergence of communications, computing and consumer electronics, while driving long-term shareholder value, we are also mindful of our heritage and our commitment to service our long-standing customers. It also informs us our drive to scale our infrastructure and to continuously improve our operational excellence in quality. Therefore even in the short term, we remain as focused on our profitable growth. With that in mind, we endeavor across the company to deliver on the second fiscal quarter and drive hard to identify and create sustained prospects for the rest of this fiscal year. Michelle, this ends our call and let me say that we look forward to updating you on our results for the current quarter and our outlook for Q3 both during our second fiscal quarter conference call now scheduled for January 31, 2018. Thank you very much.

**Operator**

Ladies and gentlemen, thank you for participating in today's conference. This does concluded the program and you may all disconnect. Everyone have a great day.