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IIVI - Q3 2017 II-VI Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the II-VI Incorporated FY '17 Third Quarter Conference Call. (Operator Instructions) As a reminder, this call is being recorded. I would now like to introduce your host for today's conference, Ms. Mary Jane Raymond, Chief Financial Officer. Ma'am, you may begin.

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

Thank you, Skyla, and good morning. I'm Mary Jane Raymond, the Chief Financial Officer here at II-VI Incorporated. Welcome to our third quarter earnings call for fiscal year 2017.

With me on the call today is Dr. Chuck Mattera, our President and Chief Executive Officer. And as a reminder, this call is recorded on Tuesday, May 2, 2017. 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.

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

Thank you, Mary Jane. And thank you, everyone, for joining us. Our third quarter was terrific. The industrial and communication end markets were very strong for us across all 3 segments. Our revenues of $245 million set a new record, while the EPS of $0.35 per share was in the top end of our guidance.

Our Q3 bookings of $281 million also hit an all-time record for II-VI.

Regionally, our revenue distribution was 45% in North America, 21% in Europe, 18% in China, 8% in Japan and 8% for the rest of the world, very similar to the FY '16 annual percentages. By end market, our revenues for this quarter was 45% in communications, 37% in industrial and semicap, and 10% in military. The comparative full year FY '16 split was 37%, 42%, 13%, respectively, on $827 million of revenue.

In the communications market, we had $110 million in revenue this quarter, 82% of which was in Photonics, 10% in laser solutions and 8% in Performance Products. Revenues into the communications market grew overall 50% year-over-year and 5% sequentially. All main market drivers we've been discussing are reflected in the strong bookings and revenues, specifically China Broadband, the 100G Metro upgrade, CATV infrastructure investments, the expansion of the data center the medications market and the growth in undersea fiber-optic networks.

Communication products deployed in Metro and long haul network builds, including data center interconnects, were approximately 67% of our communication sales. CATV network builds were another 10% and then 6% from submarine networks, 6% from Datacom, including intra-data center communications and 10% from products used in wireless base stations where our wide band gap electronic materials enable the rapidly growing 4G base station market and are paving the way for next-gen 5G deployments.

More than 51% of our communications product revenue in the quarter was derived from incorporation into rural systems. Sales of these products, including pump lasers, amplifiers, channel monitors, tunable filters, micro-optics and line cards grew 25% to 30% year-over-year and 10% to 15% sequentially. We are a strategic supplier of high-performance and high-reliability components for customers who build their own line cards. In those applications, our content typically ranges from 20% to 40% of the VAL value, usually the largest component of the manufacturing cost. Our products enabling transponder modules in CFP 2 and CFP 4 transceiver embedded in the amplifier solutions for 100G, 200G, and 400G coherent transmission made up about 15% to 20% of our communications revenue and grew 48% year-over-year.

We believe that this demand is driven by the growth in the data center and the interconnect market as well as network infrastructure upgrade markets and is a reflection of our industry-leading product portfolio. At the optical fiber conference, we recently announced our new 3 pin pump laser, which we believe is the smallest on the market, along with a miniature tunable filter, both designed to enable even more compact, lower power consumption transceiver-embedded amplification. We believe the product volumes serving this market demand will grow about 20% per year.

What's more exciting is that these miniaturized products are not just for coherent transceivers, but also for the new category of ECI transceivers based on PAM4 technology. We acknowledged that throughout this quarter a number of the market dynamics begin to shift. There has been rising concern about slowing in various parts of the market due to the apparent need for some customers to reduce inventory. While we believe there was not a great deal of inventory of our products, customers have brought renewed pressure on pricing as their demand in the industry's supply have come closer to equilibrium. At the same time, we began to see price increases from our supply chain partners who have expanded capacity or incurred other incremental operating costs as they worked to keep up with strong demand. For II-VI, we began working with customers several quarters ago on longer-term agreements for them to buy in exchange for longer-term agreements for us to supply. We've also required to expand our share, both with existing and new products. These actions, along with what we believe has been a prudent and opportunistic approach to capacity expansion and a constant focus on our supply-chain cost served as well in this just-closed third quarter and should help us withstand potentially slower demand in Q4.

We are, therefore, guiding a bit conservatively for Q4, since we know that we are not immune to market factors, although we will require to deliver strong end to fiscal year 2017.

In our industrial markets, including semiconductor capital equipment focused on advanced laser processing, the quarter's revenue was just under $92 million. It was split 70% from Laser Solutions, 17% in Performance Products and 13% from Photonics. This revenue grew 5% both year-over-year and sequentially and is split 34% for 1-micron laser applications, 31% for high-power industrial CO2 laser applications, 18% for semiconductor photolithography and 17% for precision laser optics used in applications up to 1 kilowatt for marking and engraving. Industrial end markets drove 77% of Laser Solutions segment revenues, and you can see the influence of the market momentum in the 25% sequential bookings growth.

The infrared optics division delivered an excellent quarter on record bookings and record revenues, and they enter Q4 with a record backlog. The strong demand for our precision laser optics for up to 1 kilowatt applications is being driven by the broad-based industrial activity underway around the world as factories that make high-volume consumer goods gear up for the next generation of consumer electronics and the seasonal increases. These applications need precision cutting, drilling, marking and engraving. This is also driving demand for our products into the growing EUV application market used to process the next generation of integrated circuits that are expected to be increasingly at the core of these consumer products.

We remain excited about the long-term value of the investments we're making at opto-electronic device platform. One of the next products for this platform will be VCSELs for 3D sensing. I'm pleased to say the opto-electronic devices group has passed certain key qualification milestones for mass production of volumes of VCSEL arrays that are forecasted to be required at the back end of this calendar year, with larger volumes anticipated in the next calendar year.

Now I will turn it over to Mary Jane for the financial review. Mary Jane?

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

Thanks, Chuck. As a reminder, on the second page of our press release, we share the segment details. This page details the bookings revenue and operating income by segment. The company's overall gross margin of approximately 40% is the result of another strong quarter of operating performance. Currency fluctuations positively contributed about 100 basis points to the gross margin compared to Q3 of fiscal year '16, but the sequential effect was actually pretty minimal. The operating margin for this quarter was 11.8% compared to 9.5% for Q3 of FY '16 and what has been 15.3% without this year's investment in our opto-electronic device platform. The EBITDA margin was 18.8% for the quarter. As expected, it was lower than last quarter Q2 FY '17, since last quarter had about $4 million net positive onetime items amounting to about 170 basis points. We finished the quarter with $389 million backlog and solid order coverage for Q4. The backlog consists of $159 million in Photonics, a $129 million in Performance Products and $101 million in Laser Solutions. Nearly half of that backlog is scheduled to ship in Q4. Our R&D investment this quarter was about 10% of revenue. We invested $8.5 million pretax on our manufacturing readiness program for VCSEL volume production. The capital cash flow has been about $57 million for this program year-to-date. As part of our drive to improve profitability, we exercised good control over our SG&A expenses, which were consistent both sequentially and year-over-year, despite an increase in revenue of 6% and 19%. The company had other income of $2.2 million, made up of a number of smaller onetime items. These include a gain on the sale of one of our facilities in Florida, as part of our facility consolidation in our Military business that we completed last year, a settlement agreement with a former customer, and certain income recorded from the sale of the RF business that we completed last year. Other income was partially offset by $1 million in foreign exchange losses, which are classified in nonoperating expense and by increases in equity-based compensation, which are recorded in SG&A. We've $4.5 million in share-based comp for the quarter. For the full year FY '17, we expect share-based compensation to be between $13 million and $15 million, higher than our normal $12 million to $14 million, due to more grants outstanding and the increased share price. The year-to-date tax rate is 26%. The tax rate for the same period last year was 17.1% and was due to the reversal of FIN 48 reserved for expiring statutes of limitations. The EPS in the quarter was $0.35 a share. EPS was affected in the quarter by our reaching the next tier of commercial terms with customers as volumes and share have increased, as well as pressure from certain suppliers in response to supply chain constraints. Our cash is $248 million, and our net debt position is $30.5 million. Interest expense in the quarter was $1.9 million compared to $800,000 in Q3 of FY '16. We've $40 million cash outflow for CapEx this quarter. Investments in all our platforms, including silicon carbide, are driving our expected capital cash outflow for FY '17 to be about $130 million. We continue to make improvements throughout the operations to help fund our investments, especially in working capital. For example, in the quarter, our DSO improved from 61 days to 58 days. We did not repurchase any shares in this quarter, and we, in fact, have not repurchased any shares so far in FY '17. We have $31 million remaining on our $50 million stock repurchase authorization. For FY '17, our excess cash is focused on funding our investment program. So we'll obviously monitor our stock buyback opportunities throughout the rest of this year.

Turning to the outlook. The outlook for the fourth fiscal quarter ending June 30, 2017, is revenue of $245 million to $252 million, and diluted earnings per share of $0.33 to $0.37. Please note that our EPS guidance includes an additional $0.05 for the depreciation expense for our CapEx investment coming online. The R&D platform investment will remain around $0.10 a share for this upcoming quarter. Our guidance numbers are all given at the prevailing exchange rates, and all of our diluted earnings per share numbers refer to diluted shares. The diluted share count is now 65,010,000 shares. Results for the same quarter last year, the quarter ended June 30, 2016, were revenue of $241.5 million and diluted earnings per share of $0.23. As we'll discuss in more detail during the Q&A, our actual results may differ from these forecasts due to a variety of factors, including, but not limited to, changes in product demand, customer forecast, competition and general economic conditions.

This concludes our prepared remarks. As we turn to our Q&A, I'll remind you that our answers to your questions may contain certain forward-looking statements, which are based on our best knowledge today and for which results may actually differ.

Skyla, you may open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Jim Ricchiuti with Needham & Company.

James Andrew Ricchiuti - *Needham & Company, LLC, Research Division - Senior Analyst of Advanced Industrial Technologies and Display, Vision and Imaging Technologies*

Chuck, I'll try to let you save your voice. Mary Jane, if you want to answer this, that's fine. But if we look at the guidance in terms of how you're characterizing the optical communications market for the June quarter, the conservatism, if we kind of parse through that, how much of that is related to China versus some of the other segments of the market?

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

First of all, as we discussed, the markets around the world, including China, but including the U.S. and Europe, are important markets to us. I would say that slowness in any market would have an influence on that. But I don't -- I wouldn't say that our guidance is set this quarter with emphasis primarily on only one major driver.

James Andrew Ricchiuti - *Needham & Company, LLC, Research Division - Senior Analyst of Advanced Industrial Technologies and Display, Vision and Imaging Technologies*

Okay. And -- helpful. Just with respect to the industrial business. You gave some good color on that as well, and I may have missed it, but was -- it sounds like the strength you're seeing in that market, not only cuts across categories and technologies, but also across geographies. Is that fair to say? Was anyone geography particularly strong?

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

Good morning, Jim. This is Chuck. Jim, it is broad-based in every region.

James Andrew Ricchiuti - *Needham & Company, LLC, Research Division - Senior Analyst of Advanced Industrial Technologies and Display, Vision and Imaging Technologies*

Okay. And then 2 very short final questions. I know you can't talk necessarily about the timing of the VCSEL ramp. You gave some good color on that, and I appreciate that. Mary Jane, how should we think about the R&D levels associated with this? When would we expect levels to return to maybe normalized -- on a normalized R&D level going forward?

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

Okay. So first of all, one of the things we've talked about with respect to this investment is that the normalization is more a function of the R&D as a percentage of sales than it necessarily is as a strict dollar value. The company has a history of keeping up with its R&D investments as the revenue has grown over time. But I would say, it's -- we've made the investment in anticipation of volume. We would have expected it to moderate down in the '18 fiscal year. But volume does matter. I think if we were to see some dramatic delay in some market for whatever reasons, we may reconsider that. But we would expect it probably to moderate in the 7 to 9 range down from 10.

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

Having said that, Jim, we're expecting -- we're a growth company. We're expecting the revenues to grow, and our organic investment is a key part of our strategy. The company, as we look out in the next 2 to 3 years, has a great opportunity for transformative penetration into new markets. So we will continue to invest in this platform for successive generations of products.

Operator

Our next question comes from Troy Jensen with Piper.

Troy Donavon Jensen - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

But just a clarification first, Mary Jane. For the 3D sensing business, will that be reported in Laser Solutions or the Photonics business?

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

Laser Solutions.

Troy Donavon Jensen - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

Okay. So if you look at your Laser Solutions bookings, is it fairly materially here in the March quarter? Does that include any 3D sensing bookings?

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

We do have some 3D sensing bookings, but I would not describe that as the majority of it. We have seen, as Chuck described pretty extensively, very, very nice pickup in the industrial markets as well.

Troy Donavon Jensen - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

Right. Okay. So most of it came from the industrial. That's great. Okay. And then if you just look at your June guidance, up slightly on a sequential basis. Could you give us any color on Laser Solutions versus Photonics? Are you expecting Photonics to drop significantly, just modestly, relatively stable? Any color -- any additional color would be helpful.

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

Sure. So first of all, as you all know, we don't give guidance by segment, but to just give you some sense, I think first of all, as has been the case for the last several quarters, there are a number of things that are driving the company's results and its guidance in any given quarter. Optical communications is certainly one of them. And as Chuck said, we're preparing to be possibly more affected by the market factors than maybe we have been so far. But we also did a lot of work over the last several quarters to try and position ourselves not to have significant rapid falloff. So we still see very nice contribution from Photonics. In the Laser Solutions business, the industrial markets are doing very, very nicely and began to show a resurgence even as early as the September 30 ended quarter. So we expect to see some nice lift there. The other one in Performance Products business is what we've talked about for a while here, which is the increasing demand for silicon carbide product, among other things, including military stepping up a little bit. But the Performance Products segment also is anticipating some nice growth, both in silicon carbide but a little bit gated by capacity and in the military market.

Operator

Our next question comes from Mark Miller with Benchmark.

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

Just going back to the R&D expenses again. You said they're going to basically scale with sales, but trend down to 7.9% of sales. What's kind of the relative time frame for that scaling?

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

Yes, so first of all, I'm sorry if I was not terribly clear. I said that they'd probably be in the range of 7 to 9. And as Chuck clarified, investment in R&D is kind of the hallmark of this company. But in any event, I think we would see maybe a little bit of a trend down in the '18 year. It's a little bit relevant to when volume starts in certain quarters. Again, not just in VCSELs but silicon carbide, et cetera, and then probably moderate a little bit over time. But I would say very similar to what Chuck has said that the expansion of capability in a few quarters, including in industrial and silicon carbide, et cetera, as demand starts to increase for different types of applications, we would continue to have some investments, possibly not at this level as a percentage of revenue, to exploit markets that really have not been that present before.

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

Sorry if I missed this, but again, keen interest in the VCSELs and the ramp and what's going on in New Jersey. Again, I apologize if I missed it, but you've always -- in meetings I've had with you, indicate it was more of a 2018 opportunity. Any changes there?

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

Mark, this is Chuck. Mark, we are still believing that our initial manufacturing ramp will take place by the end of the calendar year 2017, and that it will be following on by a larger ramp in calendar year 2018. Still the same.

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

Okay. So coming up later this year and the bigger part of the ramp's next year. Are you pleased with the progress of the transfer into New Jersey facility? Are you on schedule?

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

Mark, I would say that it's not uncommon at this stage of an initial ramp that we have our challenges. I'm very pleased with the progress that we've made. I believe that we'll be successful in achieving the initial ramp and we will continue to make the improvements that we need to be ready to address the larger volumes that come into the marketplace and we'll compete for in calendar year 2018.

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

I just wanted to check something. Your backlog was $380 million or $389 million?

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

$389 million.

Operator

Our next question comes from Dave Kang with B. Riley.

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

Just on the op-com segment, is it mostly China as far as the slowdown? Can you just talk about the other markets, and more specifically, can you just talk about products you highlighted some of the products that are enjoying strong demand, but what about, on the flip side, which product seems to be impacted by the slowdown the most?

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

Dave, let me try to take it. We are running our PONs amplifiers and our passive components mines at 90% to 95% capacity. So from the point of view of a slowdown, when you say slowdown, we're running pretty much quarter-over-quarter with our plan almost exactly as we expected. So we're not seeing or expecting any significant slowdown in any one part of the market that can't be made up mostly from another part. That's a generalized view. With regard to the access market where we have a very small part of our revenues, we have seen that the fiber-to-the-home market in the third quarter was down 10% to 20%, I would say, a quarter before. But it will not have any material impact on our outlook in Q4. It does not.

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

Got it. And then I may have missed it, Mary Jane, but could you give out the CapEx outlook for the rest of this year, so I can -- I guess, I can back out the first 3 quarters for fiscal fourth quarter?

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

Yes, I said that I thought it would be about $130 million.

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

Got it. Okay. And then on the 3D, some of your competitors have kind of quantified their opportunity. What do you think your market share? Any preliminary expectation at this point?

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

We have not quantified expectations of market share and don't expect to. What I can say is that we have made significant investments in the capacity and the capability to be an important player in this market. But ultimately, the customer decides the timing, what product is launched and based on that type of variability that exists entirely in the customers' hands, we're not putting expected share numbers out there.

Operator

(Operator Instructions) And at this time, I'm showing no further questions. I would like to turn the call back over to Dr. Chuck Mattera for closing remarks.

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

Hi. It's Mary Jane. I'll give Chuck a little bit of a rest on his voice since his answers to your questions are very important. But I will say, as we conclude our call today, Chuck and I would both like to thank the increasing number of top industry analysts who chose to join the call, especially those of you who had to get up early to do it. We're happy to have you here, and thank you very much. More importantly, on behalf of the whole ELT, we'd like to say that our Q3 FY '17 results were enabled by the absolutely unyielding enthusiasm, sense of urgency and teamwork by our over 10,000 employees, positively determined to contribute every day to the continued success of II-VI and all of our customers. Their dedication, commitment, innovations and hard work make it possible for us to deliver consistently, not only our customers' expectations, but our shareholders' expectations. The entire II-VI global team continues to pave the way for our future growth with our development and introduction of new products and by initiating new programs to improve our overall quality and drive operating efficiencies. As of today, nearly 4 weeks into the quarter, it feels like we're on track to deliver another good quarter ending in June and to cap off a great year, which will be a great testament to all of the people throughout II-VI who have worked so hard for that.

Thank you to all of you on the phone for your interest in II-VI, as we work to position the company to deliver outstanding value to the customers, our shareholders and our employees. If there is nothing more, Skyla, this will conclude our call for today.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program. You may now disconnect. Everyone, have a great day.
