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IIVI - Q2 2017 II-VI Inc Earnings Call

EVENT DATE/TIME: JANUARY 24, 2017 / 2:00PM GMT



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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the II-VI earnings call for the second quarter of fiscal year 2017. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to turn the conference over to your host for today. Mary Jane Raymond, Chief Financial Officer, you may again.

Mary Jane Raymond - II-VI Incorporated - CFO

Thank you, Sonja, and good morning. Happy new year to everyone. I'm Mary Jane Raymond, the Chief Financial Officer here at II-VI Incorporated. Welcome to our second-quarter earnings call for fiscal year 2017. With me on the call today is Dr. Chuck Mattera, our President and CEO.

As a reminder, this call is recorded on Tuesday, January 24, 2017. Any forward-looking statements we may make today are given in the context of today only. We do not undertake any obligation to update those statements to reflect events that are subsequent to today.

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

Chuck Mattera - II-VI Incorporated - President and CEO

Thank you, Mary Jane, and thank you, everyone, for joining us. Our momentum from FY2016 and our first fiscal quarter carried into our second fiscal quarter of FY2017. Our photonics team set the pace and they led the Company as we delivered a strong quarter that was marked by both record revenue and bookings. Our revenues of \$232 million and EPS of \$0.37 per share were above the top end of our guidance.

We continued to experience strong demand from a growing list of customers in two of our major end markets: communications and industrial materials processing. We enter the third quarter with a record backlog. Organic revenue grew 17% this quarter and acquired revenue was \$6.6 million. Our revenue by major end market is 45% in communications, 31% in industrial, and 10% in military.

Regionally, our revenue split 46% in North America, 19% in Europe, 16% in China, and 19% in the rest of the world. Very similar to the fiscal-year 2016 annual percentages.

Our bookings in the communications end markets were unprecedented. Those bookings and ongoing customer inquiries further validate our differentiation, the important role we play in the industry ecosystem, and underpin our confidence in our ability to deliver a strong FY2017.

The photonics segment revenue of \$101 million grew 36% over the second quarter of last year and 5% sequentially. Our bookings grew to \$136.1 million or 30% sequentially and 40% compared to the same period last year.

Those bookings included orders for products enabling the four main drivers we've been discussing: the network upgrade cycle known as Broadband China, the 100G US metro upgrade cycle, expansion in the data center communications market, and the continued investment in undersea fiber-optic communications networks.

At various levels of the value chain, from materials to high-performance components and subsystems, our products are enabling the growth of every major communications market segment. Market demand has remained high across our product portfolio, including for new products that we've launched in the last 18 months. In particular, our growth has been driven by increased demand for our enabling components for ROADM systems and high-speed transmission modules for 100G networks.

Our vertically integrated business model affords us, we believe, the shortest time to market. Though in the face of the strong bookings and growing backlog, we continue to expand capacity carefully and quickly to meet increased customer demand as we also work to shorten lead times that have increased on some of the lines in the past few quarters.

For example, we are selectively adding capacity to meet strong customer demand across our entire line of pump lasers, compact amplifiers for 200 and 400G transmission systems, WDM modules and filters, micro-optics for wavelength selective switches and tunable lasers, and 25G VCSELs and photodiodes.

In our industrial markets, revenues of \$73 million across our 3 segments grew 7% from Q2 FY2016. This end market is a substantial component of the laser solution segment. The infrared optics division had record Q2 bookings and enter Q3 with a strong backlog.

Strong demand continued for our low-power CO2 laser optics. And we believe that our growth rate was about double the market growth, which we estimate to be at high-single-digit percentages for this product family during the first two quarters of FY2017.

We now believe that we have also increased our share in the aftermarket for high-power CO2 laser optics as well. Component sales into the CO2 laser market account for 15% to 20% of our consolidated revenues.

As the fiber laser and direct diode lasers are increasingly being adopted, customers continue to rely on us to provide enabling components. During the last few years, we have successfully increased our penetration into this market. In fact, today, our portfolio products for fiber laser and direct diode lasers or the 1 micron laser market broadly also account for 15% to 20% of our consolidated revenues.

Two other areas of particular strength during the quarter were semiconductor capital equipment products, where bookings grew 16%, and demand for silicon carbide substrates for wireless infrastructure applications, for which bookings and revenue for the first half of FY2017 both grew over 50% compared to the first half of FY2016.

With respect to our major new optoelectronic device pipeline platform investment for FY2017, we continued to install capital equipment, expand our operations, and scale our capability to manufacture compound semiconductor materials that will enable us to manufacture next-generation optoelectronic devices, including VCSELs.

While the market is developing for 3D sensing, we continue to scale up both the epitaxial and the wafer fab infrastructure with process and device R&D and capital investment, as Mary Jane will discuss later.

I'll now turn it over to Mary Jane for the financial comments. Mary Jane?



Mary Jane Raymond - *II-VI Incorporated - CFO*

Thanks, Chuck. As a reminder, on the third page of our press release, we show the segment results: the details on the bookings, revenue, and operating income by segment. Tables 3 through 5 and table 7 and 8 reconcile any non-GAAP measures we might use to the important GAAP metric.

The Company's overall gross margin was 40.7% and is a solid operating result without much in the area of one-time items. Currency helped us about 100 basis points compared to Q2 of fiscal 2016, but the effect was fairly minimal sequentially. This follows a few quarters last year during which currency had more of a downward effect.

At the operating margin level, all segments improved sequentially. The reported operating margin for this quarter was 11.7% compared to 11.3% for fiscal Q2 of 2016 and would have been 15.8% without this year's investment in our VCSEL platform, which we did not have at this level last year. The EBITDA margin was 20.8% this quarter, including about 2 percentage points for unusual items, mostly foreign currency, which are reported in nonoperating income.

Our backlog is \$353 million. We had \$158 million in photonics, \$116 million in performance products, and \$79 million in laser solutions. We have solid order coverage for the upcoming quarter. We also have a growing backlog for the period more than six months out, particularly in photonics.

We mentioned last quarter for the first time that we were seeing orders for longer periods of time. Our orders for delivery more than six months out are now more than double what they were last quarter.

R&D spending this quarter was 10% of revenue. We spent \$9.6 million pre-tax on the ramp of our new VCSEL platform, mostly in engineering. The capital cash flow has been about \$32 million for this program year to date, and there has not been much manufacturing depreciation effect yet.

The SG&A expenses increased 3% sequentially, but increased about \$6 million over the prior-year Q2. The main drivers are the buildout of our IT platforms worldwide to further consolidate our multiple ERP and functional platforms, including at acquisitions, some SG&A at the acquisitions, and new business and select M&A review activities that affect our business development and legal team expenses.

The positive effect of foreign exchange and non-op income was a pre-tax number of \$5.5 million in total this quarter. This was offset by a number of smaller items, including an update to the value of an acquisition ramp and an inventory reserve for a positive effect of about \$4 million in the pre-tax numbers.

The second-quarter FY2017 tax rate is 25%. This was higher than our expected 22% for the year due to an increase in a FIN 48 reserve. Our very low tax rate last Q2 -- so Q2 of FY2016 -- of 14.4% was low due to the inclusion in one quarter of the full-year effect of the R&D tax credit, which was extended late last year right before Christmas. We now have that benefit more evenly every quarter.

The reported EPS in the quarter was \$0.37 a share and includes our platform investment of \$0.12 a share. Of the reported \$0.37 a share, about \$0.04 is attributable to the net of unusual items in the quarter post-tax, foreign exchange, the FIN 48 reserve, an increase in the earnout valuation, and an increase in the inventory valuation.

Our cash is \$246 million and our net debt position is \$17 million. The interest expense in the quarter was \$1.4 million compared to \$600,000 last year. We had \$28 million cash outflow for CapEx this quarter.

In addition to the capital for our platform investment, the growth and demand for optical and wireless communication products is driving our expected total capital cash flow for FY2017 all segments to be at least \$120 million, an increase from our prior high-end estimate of \$110 million.

We have \$3.9 million in share-based compensation for the quarter. For the full year fiscal year 2017, 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 increased share price.

We didn't buy repurchase any shares so far in fiscal year 2017. We have \$31 million remaining on our \$50 million stock repurchase authorization. For fiscal year 2017, our excess cash is focused on funding the investment program, though we will monitor carefully the stock buyback opportunities when they [happen].

The outlook for third fiscal quarter ending March 31, 2017, is revenue of \$234 million to \$244 million and diluted earnings per share of \$0.31 to \$0.36. The increased R&D platform investment will remain about \$0.11 per share this quarter.

I would just note that the guidance takes into effect our expectation that we won't have \$0.04 in the EPS of net foreign currency and other things. And it does a little bit anticipate the possible annual Chinese New Year effect.

Our guidance numbers are all given at prevailing exchange rates and all of the earnings per share refer to diluted shares. Our diluted share count is now 64,407,000 shares.

Results for the quarter ended March 31, 2016 -- so Q3 of last year -- were revenue of \$205 million and diluted earnings per share of \$0.24. As we will discuss in more detail during the Q&A, our actual tax results -- our actual results may vary from these forecasts due to a whole variety of factors, including, but not limited to, changes in product demand, customer forecasts, competition, and general economic conditions.

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

Sonja, you may open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jim Ricchiuti, Needham & Company.

Jim Ricchiuti - Needham & Company - Analyst

Couple of questions. First, on the photonics piece, the optical communications market, you are adding capacity. I'm wondering, Chuck, if you can give us any sense as to the scale of the capacity increase in maybe broad terms and the timeline?

Chuck Mattera - II-VI Incorporated - President and CEO

I would say, Jim, on the key lines as it relate to pumps, amplifiers, and passives, I would give you a sense that between 20% to 30% increase in capacity -- install capacity is what we are adding inside the rest of this fiscal year. At the moment, we are sold out, and our orders are so strong and the customer inquiry is so strong that it surely justifies and warrants a 20% to 30% increase in capacity. And that's what we're aiming to do by the end of the fiscal year.

Jim Ricchiuti - Needham & Company - Analyst

Okay. And Chuck, with respect to the industrial portion of the business, it sounds like you are seeing pretty good strength across the board. And I was wanting to follow up on your comment about market share gains in the infrared optics portion of the business.

Is that related, do you think, just to the change in ownership at one of the competitors? Anything you are doing that you think is resulting in market share gains there?

Chuck Mattera - *II-VI Incorporated - President and CEO*

Okay. Thanks a lot, Jim. Thanks for the question. I would say a few things. First of all, about a year or so ago, we reorganized the laser solution segment global sales force and go-to-market team. We have in effect more feet on the street, if you will. We are leveraging the entire sales process across the world.

And I would say that there have been some surprises -- pleasant surprises. One, Europe has woken up, it seems. So the demand from Europe was stronger in both every month of the second quarter than what we had forecasted into the experience. Second, our penetration and our success both in China in the low-power market in China and in Korea both has also been achieved.

So broadly speaking, I think by virtue of our revenues and especially the very strong bookings, it feels like the combination of increased demand and some market share gains is what added up to it.

Jim Ricchiuti - *Needham & Company - Analyst*

Okay. And final question; I'll jump back in the queue. Mary Jane, in the past, I think you had talked about full-year gross margins I think in the 35% to 39% range. Clearly you are off to a good start in the first half of the year, particularly with the gross margin you put up in this fiscal second quarter. Any update as to how we might think about gross margins?

Mary Jane Raymond - *II-VI Incorporated - CFO*

I think it's probably a pretty good bet that certainly on the gross margin we'll probably lift the bottom end of that margin to 40% -- the top end to 40%, which I think is right now at 36% to 39%. And as you say, it has been a good start to the year.

Jim Ricchiuti - *Needham & Company - Analyst*

But as far as looking out over the balance of the year, nothing necessarily that's going to change the margin profile significantly?

Mary Jane Raymond - *II-VI Incorporated - CFO*

Well, obviously, we don't give guidance for the whole year. But I do think that based on Chuck's commentary and some of the really outstanding work that our guys have done not only in achieving volume efficiencies, which we've said for time immemorial is important for a materials growth company.

But also I think just in achieving general operating efficiencies. I don't -- I see them with the volume continuing to maintain pretty decent margins. But I would not forecast the gross margin for the whole year. Only saying that on the range we have out, we may take the top end up.

Jim Ricchiuti - *Needham & Company - Analyst*

Okay. Thanks very much. Congratulations on the quarter.

Operator

Troy Jensen, Piper Jaffray.

Troy Jensen - Piper Jaffray & Co. - Analyst

Congrats on a really good quarter here. I guess I wanted to ask a question on the bookings, specifically the photonics bookings. Was all the strength coming from the communication products or was there any 3D sensing contribution in the bookings number?

Mary Jane Raymond - II-VI Incorporated - CFO

Well, with respect to the photonics bookings, I would say that we continue to see in the more industrial side of the business very, very nice booking. It's -- obviously on the part of the photonics segment that serves industrial, they do provide some of the passive components into the communication side. So that would be communications driven.

But the side that we refer to internally as photop actually continues to have some very, very nice bookings. And is an absolutely important part of that segment.

Troy Jensen - Piper Jaffray & Co. - Analyst

Okay. Understood. I was just curious if there's any 3D sensing contribution in that bookings number?

Chuck Mattera - II-VI Incorporated - President and CEO

Good morning, Troy. This is Chuck. Troy, just to add on to what Mary Jane said or just to underscore, we've had really, really strong -- in both groups in the segment real strong demand coming from the communications markets as well as the industrial markets, especially the industrial materials processing markets.

And whereas the interest is increasing and the interactions at customer interfaces are increasing around optics and optical components for the 3D sensing market, we did not have any material revenue in the quarter related to 3D sensing in the communications market.

Troy Jensen - Piper Jaffray & Co. - Analyst

Perfect. Thanks, Chuck. That sounds like that's on the come here [today]. Two other questions -- can you helping out with your optical business out of photonics. How much is datacom versus telco?

Chuck Mattera - II-VI Incorporated - President and CEO

Okay. We'll give you a sense for that in our -- we generally don't break it out this way, Troy. But I would give you the sense that our strength has been in the long-haul market and in the metro markets. And these days, with the advent of very large hyperscale data center interconnect and a portfolio of products which are enabling those high-speed transition modules so far as into the data center market, our exposure to the data center market is rapidly growing.

I would give you a rough idea today that maybe 20% to 30% is exposed to the data center market and growing. So the balance would be a very small amount in the access market and the balance of it would be in the long-haul and 100G metro market that you might currently identify.

Troy Jensen - Piper Jaffray & Co. - Analyst

All right. Thanks, Chuck. And then a last question and I'll cede the floor. There's been a lot of chatter this quarter just on China demand. Some people have called out kind of a pause in the first half with a second-half surge. Others think is going to be more linear this year. I would just love to hear your thoughts on the China demand throughout the year?

Chuck Mattera - II-VI Incorporated - President and CEO

Okay, Troy. For the rest of our fiscal year, I would give it to you in the sense of the captain of a ship. It's full speed ahead. For the rest of our fiscal year in China, I do not see or foresee any slowdown or any downshifting. It's full speed ahead.

Troy Jensen - Piper Jaffray & Co. - Analyst

Awesome. Thank you and good look for the remainder of 2017.

Operator

Ted Moreau, Terrace Research.

Ted Moreau - Terrace Research, LLC - Analyst

Thank you and congrats on a great quarter. That's fantastic to see, guys. So just getting back to the China question, particularly on the communications side, can you maybe compare this year's Chinese New Year's effect to last year's? Is there any differences there or -- I know Chuck said full speed ahead, but I'm just trying to see if I can compare maybe how things are year over year, maybe particularly in the March quarter.

Mary Jane Raymond - II-VI Incorporated - CFO

No. Every year, we talk as we give guidance for the March quarter that there can be a Chinese New Year effect sometimes with the way the timing falls, sometimes with the mix of product, which operators are on which lines.

But I think you are about to hear from Chuck here in a little bit that we have a number of extraordinarily dedicated people in China that are probably going to work through Chinese New Year. So no, we give this pause every quarter; there's nothing new compared to last year.

Chuck Mattera - II-VI Incorporated - President and CEO

Good morning, Ted. Ted, I'll underscore that. I would say first of all, fortunately, we always have 12 months to plan for Chinese New Year, and plan we do. I would say one thing that's a little different about it -- I'll make mention of it in closing remarks -- is we have more people that need to work through this Chinese New Year than did last year.

Ted Moreau - Terrace Research, LLC - Analyst

That's great. And so last year, we saw the broadband -- the China PON -- broadband business slow down a little bit throughout the year. So has that started coming back already or do you expect that to pick up maybe following the Chinese New Year?



Chuck Mattera - *II-VI Incorporated - President and CEO*

Ted, I'll take that. I know this has been -- it's a recurring interest about the magnitude of the market and the like is that the -- our play in the access market and our position in the access market, first of all, was important. We are a key provider of certain filters into the market.

And in the scheme of our photonics business, it's a small part of our business but an important part for our manufacturing drivers and our revenue and profit. Bottom line is that I expect, if anything, a continued increase in the demand for those filters into the access market as we head into the second half of this fiscal year.

Ted Moreau - *Terrace Research, LLC - Analyst*

Sounds good. So final question, turning to 3D sensing, can you just give us a sense for what the timing is of -- that you anticipate initial orders and to start shipping for volumes? And then what the initial applications are? I know that there is a lot of chatter around smartphones. Is that the primary application that you're seeing initially or are there other applications early on that are driving interest as well?

Mary Jane Raymond - *II-VI Incorporated - CFO*

So let's just talk about timing. So timing for the beginning of shipments is the second half of calendar 2017, at least that's what we understand by kind of all indicators now. And we have worked with a lot of customers on the potential that 3D sensing potentially has in a whole wide variety of applications. And consequently, because we also don't control the launch dates, we are not really speculating on what we think the initial applications will be.

Ted Moreau - *Terrace Research, LLC - Analyst*

Okay. Great. Thanks. I'll pass it on.

Operator

Mark Miller, The Benchmark Company.

Mark Miller - *The Benchmark Company - Analyst*

Congratulations on your record results again. Very impressive string of quarters we've had here. Just was wondering about the CO2 laser market. Can you give us some estimates in terms of total new laser installations this year, what percent? And if possible, the number of lasers that were CO2 and how does that compare to the year before?

Chuck Mattera - *II-VI Incorporated - President and CEO*

Good morning, Mark. Thanks for your comments. Sure. Let me give you a sense in a continuum for the number of high power CO2 lasers that are being built. And I'll compare it to what we believe to be the high-power fiber laser newbuilds as well.

I think at the moment, our checks for the last quarter suggests that about 100 to 125 new high-power CO2 lasers were built on average per month in the calendar year 2016; so about 125. And I would give you a sense that that's probably in the 10% to 20% or 15% to 30% range of the total. So that means that fiber lasers might be three to four times that much -- high-power -- new high-power fiber lasers.



And I think the rest of your question was about the net. So that would put the total number at about 5,000 to 6,000 in that range for new high-power lasers into the marketplace. And about 20%/25% or so maybe in CO2. That number has or percentage has been declining over last year as we've reported in the last three or four quarters.

And as far as the retirement rate go (sic), we have a model about that. And our model suggests that it's about at equilibrium at the moment.

Mark Miller - *The Benchmark Company - Analyst*

Okay. I was just wondering -- you reported that you had seen an increase in your backlog going beyond six months. Is that primarily optical telecom and what products are responsible for that?

Mary Jane Raymond - *II-VI Incorporated - CFO*

As I indicated, it is mostly in the photonics segment. And it's a mix of products at this point in time. I think that the issue is not so much particular products as it is really -- it's become a little interesting recent phenomenon from last quarter on to have more than little bit in the post six-month period.

Mark Miller - *The Benchmark Company - Analyst*

And then finally, just a little more color on -- you mentioned the opportunity in 3D sensing, but also specifically in VCSELs. In terms of your strengths, what are you currently -- what market -- I assume it's the optical telecom market you are serving out of Zurich. What are your strengths vis-a-vis with your competitors and how much revenues currently are you deriving from VCSELs?

Chuck Mattera - *II-VI Incorporated - President and CEO*

Okay, Mark. That's a good question. First of all, our VCSEL, the revenues that we generate today from selling VCSELs is coming basically from two different markets. They're founded on the strength of our laser enterprise design and manufacturing team in Zurich using the 3-inch fab.

As you know, we've reported that that team are a market leader of VCSELs for the laser computer mouse market, where we are a very high-volume producer of VCSELs, and the data center market in particular. And its increase in demand is driving an increase in VCSELs required for both 10G and 25G VCSELs for active optical cable and for transceivers into that marketplace.

And that business has experienced a rather considerable uptick in demand in the first six months of our fiscal year compared to any of the six-month periods last year.

Mark Miller - *The Benchmark Company - Analyst*

And your advantages -- your competitive advantages in the space currently and where it might be once you ramp your production in the US. What do you think your advantage there also in terms of packaging hermetically sealed versus non-hermetically sealed type lasers?

Chuck Mattera - *II-VI Incorporated - President and CEO*

Most of the VCSELs that we sell, we sell as bare die. And I would say that our advantages include a world-class design team, an ability to understand and translate customer requirements quickly into a set of products and form factors that are required by them, and then to be able to scale and ramp the volumes to meet their requirements.

And as you know, that design team is intimately involved with the ongoing development and scale of the technology from Zurich into the 6-inch gallium arsenide wafer fab here in Warren, New Jersey. So we have really a great structure with an efficient -- a fast, efficient, and focused design and manufacturing team in Zurich with an expanding team with a large capability to scale here in Warren, okay?

Mark Miller - *The Benchmark Company - Analyst*

Thank you. And again, congratulations on another strong quarter.

Operator

(Operator Instructions) Dave Kang, B. Riley.

Dave Kang - *B. Riley & Co. - Analyst*

Good morning. Great results. First of all, a question regarding your outlook assumptions. Are we expecting both optical and lasers to be up sequentially in fiscal third quarter?

Mary Jane Raymond - *II-VI Incorporated - CFO*

Well, we don't give guidance by segment, but I would expect at the revenue level, normally both of those segments do see a lift in the third quarter.

Dave Kang - *B. Riley & Co. - Analyst*

Got it. Regarding VCSELs, certainly a lot of questions already. You said volume to ship in second half this calendar year, as far as a 3D sensing opportunity is concerned, what kind of volume should we expect?

And can you just talk about the current capacity and where your capacity needs to be and how quickly can you ramp? I assume some of those equipment have long lead times, right? So can you just go over those items, please?

Mary Jane Raymond - *II-VI Incorporated - CFO*

Sure. So first of all, with respect to volume, we've made no comments and aren't today on expected volumes. Again, I think one of the tricky things is we don't control the customers' launch schedule, which is always tough as an intermediate goods manufacturer.

With respect to capacity, the capacity here in the former ANADIGICS, our optical electronic device division, is fairly well known I think in the industry in terms of what it shipped in terms of more RF-related products before. It's considerably larger -- couple of factors larger than our Zurich. So having six-inch obviously is an important part of that.

And with respect to your question about scale, first of all, being able to scale quickly, as Chuck mentioned a few times, is an important factor across all of our segments. But as you said, because the equipment has long lead time -- we have \$32 million of capital already cash flowed to make sure that the machines are getting into sort of mint and fighting condition. The instrumentation equipment is where it should be and the same where it needs to be around world.

So while it is certainly true they have long lead times, we've known that for a while. And that's part of the reason that we indicated coming even into the first quarter that we would be seeing capital at a higher level.



Because we knew, as you say, that we would need to be able to order that and start to get it in place in time for the ramp. So as Chuck mentioned, we are continuing to scale both in terms of people capabilities and capital to be in a position to be able to serve the market as we see it evolving.

Dave Kang - *B. Riley & Co. - Analyst*

Sure. So for those not familiar with ANADIGICS, can you just remind us what the current capacity is and where you want to be maybe by end of this year? Are we talking about maybe going from \$10 million to \$50 million? Any type of numbers of quantifiable information you can share with us?

Chuck Mattera - *II-VI Incorporated - President and CEO*

Dave, good morning. This is Chuck. Dave, we are not prepared to be getting into volumes are or to be quantitative about our capacity or utilization. It's too early for that.

Here's what I would like to add, though. We believe that there is considerable interest and commitment to add functionalities that require semiconductor lasers. And the plan that we're running hard at anticipates us beginning to realize the opportunity in the back half of the calendar year, as Mary Jane said.

We are really excited about the opportunity that lies before us so we can continue to invest in equipment, facilities, new employees, and the development of the technology. So your point earlier, just to come back to it straight: yes, we are adding a considerable amount of capital equipment both to enable us to have the targeted capacity so that we can fully utilize the other assets that have.

And that we are also adding new tools because we're adding new processes that are required to manufacture a laser, and especially a VCSEL laser, that were not included in the gallium arsenide HEMT and bi-HEMT lines when we acquired the business here at ANADIGICS. I hope that helps.

Dave Kang - *B. Riley & Co. - Analyst*

Yes, it's very helpful. And compared to like, say, one or two quarters ago, what's your confidence level? What's your conviction level as far as this 3D sensing happening? Some of your competitors, they say there are still some milestones to be cleared and all that. What's your conviction level here?

Mary Jane Raymond - *II-VI Incorporated - CFO*

First of all, there are probably milestones to clear all the way up until the day there's revenue. But I think Chuck could probably not have put it better than he just did. We are very, very bullish on the development of this market and are continuing to work very, very hard to be in a position to serve it.

Dave Kang - *B. Riley & Co. - Analyst*

Got it. And then just a few questions around the optical segment or photonics segment. Chuck, you'd mentioned North America, China, DCI, and submarine. I'm assuming you are not going to break out those by numbers, but can you tell us which is the -- can you just rank those in terms of -- in a size?

Mary Jane Raymond - *II-VI Incorporated - CFO*

Well, let me just answer one question on submarine, which we've said a few times, which is the submarine market, while not a huge revenue driver, it's by far probably the smallest revenue driver. It's a market that is a reasonably decent margin.

The components in that are hard to make; they require tremendous toughness and longevity in that system. And consequently, we mention it because it's important to us and we're good at it. But that's easily the smallest one, so I'll leave you that one.

Chuck Mattera - *II-VI Incorporated - President and CEO*

Dave, let's see. Our portfolio includes coverage into the cable TV infrastructure market, as you know. Let me just give you the following summary.

First of all, our cable TV infrastructure business is growing. We like to think about that in the context of the metro market. It's highly focused in the US, so for us, the rapidly growing cable TV business is part of our view of the metro market. That's one thing.

Second thing is the submarine market, when we talk about it, we talk about it and think about it as a derivative of the data center interconnect market. In fact, the data center interconnect market is actually a derivative of the submarine communications networks.

In that business, we have a suite of components which are absolutely essential to the performance of the network. And I would say that in this first half of the year that the strength of our bookings and the demand from our customers has never been higher. Our orders increased to a historical high during the second quarter as it relates to the submarine market.

So -- and also, this rapidly growing CFP2/ACO/DCO market that many of our customers are talking about is highly dependent for some very important components that we provide into the marketplace to many other people that are driving those products.

Dave Kang - *B. Riley & Co. - Analyst*

Got it. And then you talked about that you were sold out. Can you specify for which products or is it more of a general comment?

Chuck Mattera - *II-VI Incorporated - President and CEO*

I made the comment specifically in the context of some pump lasers, some amplifiers, and some passive components, including (multiple speakers).

Dave Kang - *B. Riley & Co. - Analyst*

So it sounds like it's more ROADM related. Is that a fair statement?

Chuck Mattera - *II-VI Incorporated - President and CEO*

It's not only ROADM related, but it's ROADM related in part because we're such a strong provider of leading components to people who make -- the large makers of ROADMs and wavelength selective switches.

But we are adding capacity, Dave. We're adding it quickly. And some of the products, they're specification-dependent. But across those platforms of pumps, passives, and amplifiers, we have had to push out lead times in our responses to customers who were hanging in there with us as we commit to add capacity. And we are.

Dave Kang - *B. Riley & Co. - Analyst*

And then regarding the ROADM-related products, do you know if that's for the Verizon supply chain or is it more of a US market in general?

Chuck Mattera - *II-VI Incorporated - President and CEO*

I believe that it's our feeling that it's more than just a single customer and a single metro upgrade. We are serving customers who are expanding the metropolitan networks to 100G in US and in Europe as well and in other parts of the world.

Dave Kang - *B. Riley & Co. - Analyst*

Got it. Just a couple more regarding the Chinese market. So you said full speed ahead when asked about the Chinese demand. So should we expect continuous sequential growth going forward? Or can you just clarify what you meant by full speed ahead?

Chuck Mattera - *II-VI Incorporated - President and CEO*

We will continue to put the sustained effort that we have into the marketplace. That's one thing that I mean. Second is that since our output is constrained at the moment -- we have constrained capacity -- I do expect that we'll see incremental growth. But the growth rates and revenue now will be dependent on our ability to break through the constraints.

So the orders are strong, as Mary Jane said. Some of the orders are spilling over into what will be our fiscal year 2018 already. And for sure, the engagements that we have with customers inside China suggests that their demand will continue at this sustained pace. That's what I mean by full speed ahead.

Dave Kang - *B. Riley & Co. - Analyst*

Got it. And some of your -- last question is some of your competitors talked about this Phase 11/Phase 12 tenders and all that. Do you know if tenders for Phase 12 been awarded already? Do you know what the status of that is?

Chuck Mattera - *II-VI Incorporated - President and CEO*

No, I don't, Dave. We generally -- I've heard or read some analysts talk about Phase 11 and 12. Our customers don't talk to us in the context of those phases, so we're not able to do a decent mapping for you of our bookings and our order patterns to those phases.

Dave Kang - *B. Riley & Co. - Analyst*

Got it. Thank you.

Operator

Mark Miller, The Benchmark Company.

Mark Miller - *The Benchmark Company - Analyst*

Last quarter, you broke out orders in terms of optical telecom. I was wondering if you could do that; I think it was about \$100 million of the total orders. Can you do that for this quarter?



Mary Jane Raymond - *II-VI Incorporated - CFO*

The difference between optical as far as are between --?

Mark Miller - *The Benchmark Company - Analyst*

Optical communications.

Mary Jane Raymond - *II-VI Incorporated - CFO*

Just repeat the question again, Mark?

Mark Miller - *The Benchmark Company - Analyst*

I think -- again, if I recall correctly, you broke out your orders in the optical communication last quarter. I believe they were around \$100 million. I'm just wondering what they were this quarter -- for the total --.

Mary Jane Raymond - *II-VI Incorporated - CFO*

Oh, sure. It's a little bit up, so I would have said if we just looked at that part of the market, it was probably about maybe \$96.5 million. So we would have rounded that to \$100 million. And it's probably about a little over that now; pretty commensurate with the growth we saw on the revenue line at least in the quarter for photonics.

It's not all in photonics, as we've said. But it's probably commensurate with how you are even seeing the segment reported from Q1 to Q2.

Mark Miller - *The Benchmark Company - Analyst*

I missed in terms of your sales breakout industrial/military. I think military was 10%. Was industrial 31% and what was the 45% for?

Chuck Mattera - *II-VI Incorporated - President and CEO*

For optical communications, that includes our play into the wireless communication market as well, Mark.

Mark Miller - *The Benchmark Company - Analyst*

Okay. Thank you.

Operator

Dave Kang, B. Riley.

Dave Kang - *B. Riley & Co. - Analyst*

Just couple more questions I forgot to ask. Can you just talk about how the pricing negotiations went for optical segment?

Chuck Mattera - *II-VI Incorporated - President and CEO*

Okay, Dave. Sure. Basically I would say very positive. We have some customers, as you know, who we may negotiate with every quarter, some on an every six-month basis, and some on an annual basis. I would say we're very pleased with the results of those negotiations.

Dave Kang - *B. Riley & Co. - Analyst*

And how does it flow through to your bottom line as far as like margins are concerned? Is that something that you can quantify for us or not?

Mary Jane Raymond - *II-VI Incorporated - CFO*

No. We -- as Chuck said, there are certainly some other peers in the industry that perhaps have all of their negotiations just going into the March 31 ended quarter. But in our case, we have some that are throughout the year.

I think what we said throughout pretty much this whole part of the upcycle, let's call it, is that if pricing negotiations had been not only every quarter but quite aggressive in the past when maybe the cycle was not as strong, we've certainly seen that, as Chuck said, a little bit more positive environment now. But we've never in any of the quarters we've reported talked about the impact of price negotiations.

In any event, no matter what it is, I would say our teams are hugely committed to the ongoing management of their margin and will work then very hard to understand what the operating efficiencies are they can achieve to deal with that. Particularly in a market that's known to have ongoing expectations of pricing reductions.

Dave Kang - *B. Riley & Co. - Analyst*

Got it. And the last question is -- maybe I'm nitpicking here, but I believe you said last quarter's call you expect the momentum to last through end of -- well, second half of calendar year 2017. But now in the press release, you talked about second-half fiscal year. So just wondering why the change in rhetoric?

Chuck Mattera - *II-VI Incorporated - President and CEO*

Dave, we're focused on being sure that we're clear on this fiscal year. And we will come back and give a guidance of our best view in April for the second half of the year. But I'm happy to take that on and say as a follow-up answer to a follow-up question that even as we sit here today, my comment from 90 days ago stands. I think the second half of the year is likely to continue to be a good environment for us.

Dave Kang - *B. Riley & Co. - Analyst*

Got it. All right, thank you.

Operator

Thank you. And ladies and gentlemen, this does conclude our question-and-answer session. I would now like to turn the call back over to Dr. Chuck Mattera, President and Chief Executive Officer, for any further remarks.



Chuck Mattera - II-VI Incorporated - President and CEO

Okay. Thank you, Sonja. To conclude our call today, I'd like to say that our Q2 FY2017 results were enabled by the unyielding enthusiasm, sense of urgency, and teamwork of our nearly 10,000 employees determined to contribute to the success of II-VI and our customers.

The dedication, commitment, innovations, and hard work of all of our employees made it possible for us to meet customer expectations, including through the year-end holidays in the US and Europe as well as through Chinese New Year about to again on January 26, during which over 1,000 of our dedicated Chinese employees have volunteered to put our customers first and work right through.

The entire II-VI global team continues to pave the way for our future growth with the development and introduction of new products and by initiating new programs to improve our overall quality, operating efficiency, and enabling our growth.

As of today, nearly four weeks into the quarter, it feels like we are on track to deliver another good quarter ending in March. Thank you for your interest in II-VI and for your questions today. Sonja, this concludes today's call.

Operator

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

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