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IIVI - Q4 2017 II-VI Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the II-VI Incorporated 2017 Fourth Quarter and Full Year Conference Call. (Operator Instructions) As a reminder, today's conference is being recorded. I would like to introduce your host for today's conference, Ms. Mary Jane Raymond, Chief Financial Officer. Ma'am, please go ahead.

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

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

With me today on the call is Dr. Chuck Mattera, our President and Chief Executive Officer. And as a reminder, this call is recorded on Monday, August 7, 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 fourth quarter concluded a phenomenal year. Through the fourth quarter, up to today, we also successfully completed 2 acquisitions to strategically expand capacity to serve our customers, developing proven new technologies and begin shipments of some of our new products.

Let me point out a few of the many milestones in fiscal year '17. Record bookings of over \$1 billion for the first time ever with 22% growth over FY '16. Record backlog of \$399 million. Recorded revenue of \$972 million with 18% annual growth and strength in all of our end markets. Record Photonics segment annual revenue growth of 28%. 21% annual revenue growth and 17% sequential revenue growth in China. More than 50% annual growth in bookings and revenue in our silicon carbide substrate division. And finally, our continued long-term investments to assure our position in the exciting market transformations underway and in which we intend to be a market leader.

We completed 2 strategically important acquisitions, both of which will help us meet the increased demand for products in growing markets. Integrated Photonics, or IPI, was acquired for \$45 million on June 19, bringing to II-VI a market-leading position in magneto-optic Faraday rotator



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materials, essential to all isolator components used in certain optical and data communications applications as well as fiber lasers. Our Photop team will quickly scale the business to meet the rapidly increasing demand, driven by the exponential growth in data centers.

Today, IPI is less than 5% of our revenue, but we expect it to grow above 20% a year and to be accretive this year. Second, we acquired one of the best multipurpose 6-inch compound semiconductor wafer fabs in the world. Given the future opportunities we anticipate in 3D sensing and other breakthrough technologies, this acquisition was lower cost and will allow us faster time to market than for example, building a proprietary greenfield site and will allow us to have control of our manufacturing footprint, thereby enhancing our supply chain leadership position.

It adds to our in-house capacity for VCSELs and is also a part of our broader strategic move to provide a pathway to gallium arsenide, silicon carbide and indium phosphide based products.

During the last 18 months, we added capacity, developed an integrated new technology and are preparing to ramp 3D sensing VCSELs at our U.S. epitaxial wafer and opto-electronic device manufacturing sites. We will leverage our experience to accelerate the readiness of the new fab. Given our deep expertise and history in consumer VCSEL technology, we have been a designing partner for participants in the emerging 3D sensing market from the beginning. We believe that our continued investments in this and related technology and our strategic acquisitions of scalable manufacturing capacity will help us to become a leading VCSEL technology, product and manufacturing partner. To date, we have received and accepted initial orders for millions of VCSEL arrays that we intend to fulfill on a schedule controlled by our customer over the next few quarters. We have been and we will continue to work closely with the customer as part of their overall manufacturing plan. We expect follow-on orders as 3D sensing products ramp through FY '18.

From our active design engagements with a broad base of over 10 3D sensing customers, both in the consumer electronics and automotive markets, we expect 3D sensing to be a significant growth driver over the coming years. We expect that early adopters in next generation consumer electronics will enable transformative applications, including virtual reality, augmented reality and the Internet of Things as well as the automotive industry, who are looking to laser-based 3D sensing to enhance capabilities and enable new applications. These will require that we have additional capacity to develop and manufacture for multiple products and customers on tight time lines. That is among the reasons we invested in the new fab.

Now turning to our Q4 and FY '17 results. Revenue growth of 13% year-over-year and 12% sequentially was driven by a strong pickup in the global industrial markets demanding both fiber laser, direct diode laser and CO2 laser components as well as by continued demand for our optical and data communications components and subsystems, by demand for our specialty optical products for the military as well. We also saw increases in the backlog across the company.

Before turning to my review of the broad business results and prospects, I would like to briefly highlight 2 new growth areas for us. The first one is silicon carbide substrates for wireless communications and also for power electronics used in automotive applications, which accounted for a large multiyear order during the quarter. We expect that such applications of devices fabricated on silicon carbide substrates and both the wireless communications and power electronic markets to both rapidly grow from about \$200 million to \$300 million today to \$400 million to \$500 million for wireless and over \$500 million for power electronics by 2022.

Our customers tell us that we are a leading supplier of high-quality silicon carbide substrates which are essential to the growth of these markets, and we estimate that the substrate addressable market size today is about 15% to 25% of the device market revenues. Another emerging growth business is EUV lithography, where we are also seeing increased deployments as the adoption rate of EUV increases. We are part of the critical supply chain for the market leaders who are commercializing the technology and products in this exciting segment of the market. We are highly differentiated in the supply chain, having invested in the enabling technology and products before the systems were in development. We expect EUV lithography technology will drive the manufacture of smaller and smaller integrated circuits that are enabling a convergence of communications, computing and consumer electronics.

We estimate that the value of our content in these semiconductor patterning tools, which sell for over \$100 million, is about 1% to 2% of the sale price and our content includes various optics components, photonic modulators, CVD diamond windows, which are critical to the tool's high output power, uptime and throughput, plus various engineered ceramic components. Industry reports indicate that there is currently a \$3 billion backlog



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of EUV tools to be delivered over the next 12 to 18 months. These are only 2 great examples of our diverse and differentiated materials platforms that are among our growth drivers.

Turning back to the overall company. During Q4 FY '17, we experienced revenue growth, both year-over-year and sequentially. In fact, we saw a double-digit growth in North America, Europe and China. Our FY '17 sales were geographically distributed: 45% in North America; 21% in Europe; 19% in China; 8% in Japan; and 7% for the rest of the world. By end market, our revenue for FY '17 was 44% in wireless, optical and data communications combined, 37% in industrial and semiconductor capital equipment and 11% in military.

The comparative end market full year FY '16 split was 37%, 42% and 13%, respectively. China was a particularly bright spot in the quarter with sustained strength and demand for optical communications products and strong growth in both CO2 and fiber laser products. The industrial and semiconductor capital equipment markets drove another fantastic quarter with \$98 million of revenue. Demand strength continued in all regions of the world including Europe, whose increased activity we noted initially in Q3. The main drivers include: higher demand from the broad industrial sectors, the automotive sectors and the seasonal element ahead of new model launches across many end markets, including consumer electronics.

Revenue in nearly all product lines grew in the fourth quarter, including the CO2 laser optics business, which grew 11% and components for fiber lasers and direct diode lasers, which grew 17%. The composition that drove the \$98 million was 34% for high-power CO2 laser components, 32% for fiber laser and direct diode laser components, 23% for semiconductor photolithography tools and the remainder for precision optics used for laser micro-machining applications.

The communications market continued to be strong for II-VI, and we performed very well again this quarter. We saw a revenue growth every quarter this year compared to the same quarter last year. Revenues into the communications market grew overall 40% year-over-year for FY '17 and remained steady in Q4 compared to Q3. We believe that the team's solid performance in optical communications resulted in part for meaningful market share gains and increasing customer demand, especially in Datacom. Our strong positioning in China, our strong presence worldwide through our vertically integrated supply chain and our deep customer relationships have helped to ensure II-VI's steady growth faster than the market.

Our success in China continues to be broad-based, and as a result of the world-class team, key customers, careful management of full stream inventory, a diverse product portfolio and our ability to continuously evolve our products that anticipate customer requirements.

Of our \$114 million in communications revenue, 82% was generated by Photonics, 10% by Laser Solutions and 8% by Performance Products. Laser Solutions sales were largely from VCSELs and photodetectors, which experienced a surge in demand largely for active optical cable applications and Performance Products sales were largely from silicon carbide substrates. Communications products deployed in metropolitan and long haul network builds, including data center interconnects, were close to 60% of our communications sales this quarter.

Datacom, including intra data center communications was about 13% of revenue, accounting for twice the percentage of the total we had last quarter. Cable TV network builds were another 8%, followed by 7% for submarine networks and 11% from products used in wireless base stations. Our pump laser has been a key to our continued growth because of its wide deployment across terrestrial and submarine networks, its industry-leading output power, which is will matched to ROADM applications, and our unique ability to continuously miniaturize the module to enable our customers to offer the most compact, high bit rate transceivers.

More than 47% of our communications products -- more than 47% of our communications product revenue in the quarter was into ROADM systems. Sales of these products include pump lasers, amplifiers, channel monitors, tunable filters, micro-optics and even line cards. We are also a strategic supplier of advanced high-performance and high-reliability components for customers who build their own ROADM line cards. Another 14% of our sales was into 100G, 200G and 400G coherent transmission products, including CFP2 and CFP4 modules and for which we supply transceiver-embedded amplifiers and micro amplifier modules. These include pump lasers and micro-optic components and mux/demux filters. We've seen 17% growth in these products year-over-year, also due to our unique position in the industry and that we are able to miniaturize both our pump and passive components and integrate them.



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Overall, we expect that FY '18 will be another year of growth for II-VI, and we look forward to sharing our progress with you throughout the upcoming quarters.

With that, I would like to turn the call over to Mary Jane, who will provide the details of our fourth quarter results and our Q1 FY '18 guidance. Mary Jane?

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

Thank you, Chuck. And hi, to everyone on the call.

As for the just reported financial results, just as a reminder, on the second page of the press release we show the segment results. That page details the bookings revenue and operating income by segment. The company's overall gross margin for Q4 was 39.7%, representing an expansion of 130 basis points year-over-year and is a result of another strong quarter of operating performance.

The operating margin this quarter was 13% compared to 12% for Q4 of FY '16, inclusive of investments. The EBITDA margin was 20.1% for this quarter. The main difference between the operating margin and the EBITDA margin in our company is depreciation and amortization, which increased \$4 million compared to Q4 FY '16 and \$4 million compared to last quarter Q3 FY '17, as equipment for new product production comes online.

The acquisition of IPI for \$45 million is expected to be accretive in FY '18. The acquisition of the U.K. wafer fab for \$80 million is expected to be EBITDA breakeven by the year-end FY '18 and \$0.03 to \$0.05 dilutive to EPS quarterly. We finished the quarter with \$399 million in backlog, up \$10 million from Q3 and up \$110 million or 28% from year-end FY '16. In addition, we had solid order coverage for Q1. The backlog consists of \$160 million in Photonics, \$137 million in Performance Products, and \$102 million in Laser Solutions. We invested \$4.6 million pretax on our manufacturing readiness and qualification program for VCSEL volume production, \$30 million for the year. The capital cash flow has been about \$58 million for this program year-to-date. We had \$16 million in share-based compensation for fiscal year '17 compared to \$10.9 million for fiscal year '16 due to an 83% rise in the share price from June 30, 2016 to June 30, 2017 and due to a higher share price prevailing at the time of the August 2016 grant than was the stock price at the time of the August 2015 grant. The company had other income of \$400,000, made up of \$2.3 million in final payments to II-VI from the sale of the ANADIGICS' RF business, along with interest income and minority earnings.

This was offset by \$2.3 million in currency losses, primarily for the euro to dollar exchange rate. Total capital expenditures this quarter were \$40 million, bringing the total capital FY '17 to \$139 million. Compared to \$68 million in fiscal year '16, the increases were \$58 million for VCSELS and other opto-electronic devices, \$16 million for silicon carbide and \$7 million for capacity expansion in optical communications, ranging from passive optics to amplifiers. CapEx for FY '18 was budgeted between \$100 million and \$125 million. With the completed acquisitions, CapEx may range up to \$150 million depending on which growth and investment opportunities materialize. The full year FY '17 tax rate was 19.8% and was 3.6% for the quarter.

The tax rate for full year -- fiscal year 2016 was 27%, though it was affected significantly by reserves on NOLs. The tax rate for full year FY '17 of 19.8% was largely affected by the Q4 tax rate of 3.6%. The Q4 tax provision did not require the expected reserve increases, due to certain tax attributes of IPI that were consolidated into our results in June. These tax attributes passed to II-VI as a onetime effect with the consolidation. This made the FY '17 tax rate comparable to the tax rates we reported in the years prior to 2016.

For FY '18, our tax rate is likely to be in the low 20s. The reported EPS in the quarter was \$0.50 a share. EPS was affected in the quarter by the net of onetime items to the positive of \$0.04 a share netting items such as the unusual Q4 tax rate, the foreign currency loss, the true-up of accruals for company-specific HR policy changes and the transaction cost for IPI.

This compares to \$0.23 a share at Q4 FY '16 on a reported basis, and \$0.40 a share without acquisition and restructuring costs. Our cash is \$272 million and our net debt position is \$70 million. Our debt increased \$63 million for the purchase of IPI and other borrowings, since March 31, 2017. Interest expense in the quarter was \$2.3 million compared to \$1.1 million in Q4 of FY '16.



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Turning to the outlook. The outlook for the first fiscal quarter ending September 30, 2017, is revenue of \$250 million to \$260 million, and GAAP diluted earnings per share of \$0.30 to \$0.34.

This earnings per share number includes the estimated acquisition effects of the U.K. fab, including a preliminary estimate for the purchase accounting and transaction cost and also includes \$0.01 for the onetime recording of the inventory step up at Integrated Photonics. These items together are affecting the EPS by about \$0.07 a share, including about \$0.04 a share of onetime items, namely transaction cost for the U.K. fab and both inventory step ups that will not continue beyond Q1. The diluted share count is now 65 million shares.

Our Q1 FY '18 revenue guidance follows the typical seasonal pattern of flat to down 8% to 10% relative to the fourth quarter revenue largely driven by the summer being a little bit slower period for manufacturing in several regions of the world. As a reminder, this happened last year and the year before. From Q4 FY '16 to Q1 FY '17, that period had a reduction of revenue of 9% and we still delivered very nice 18% growth for the full year of FY '17. For comparison to last first quarter, the results for the first quarter ended September 30, 2016 were revenue of \$225 million and GAAP reported diluted earnings per share of \$0.26.

As we will discuss in more detail during our Q&A, our actual results may differ from these forecasts due to a variety of factors, including but not limited to, changes in product mix, customer orders, competition and general economic conditions. Further as a reminder, all of our comments on EPS earnings per share, refer to diluted earnings per share.

This concludes our prepared remarks. 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 best knowledge today, and for which actual results may differ materially.

Michelle, you may open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of David Kang with B. Riley.

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

So first of all, can I get some revenue assumptions for fiscal first quarter guide in terms of Photonics, industrial lasers and performance technologies? And also, how much revenues have been baked in for IPI and Kaiam as well as 3D sensing?

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

So first of all, obviously, we don't give guidance by our segments. I would say, that we continue to -- we expect to see in '18, growth across the segments.

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

Okay. So for first quarter, how much of revenues have been baked in for IPI and Kaiam, can you at least disclose that? Or...



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

So I would say, at this point, they're both relatively small. I'm not sure we're going to see a great surge going from Q4 to Q1. But probably, collectively together, they're in the area of about 10%.

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

10% of \$255 million, basically. Is that correct?

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

Just in the area of about 10%.

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

Okay. All right. And what about -- you broke up. What did you just say, I missed it?

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

I was saying that, again, I don't expect them to really surge greatly between where we are today, but we do expect very, very nice growth in both of them.

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

Okay. And then what about -- any color on 3D sensing. You talked about some orders and all that. How much revenue should we expect in the first quarter? And how should we think about that?

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

Okay, Dave. So thanks a lot for your questions. Regarding our FY '18 revenue potential for our initial manufacturing ramp, we are not going to be able to disclose our forecast at the outset of the ramp. It's too early to quantify with certainty due to a number of factors that are beyond our control. But I expect that we would be in full production by the end of the quarter ending in December, from the start that we have today. I would also say that we're on track with our original plan to be shipping 3D VCSEL arrays by the end of this calendar year. We are on track to the -- that ambitious milestone that we have been talking about for some time, having received purchase orders for millions of devices. And we're really, really excited about it.

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

Got it. And then, a reason for Kaiam acquisition, is it because ANADIGICS? Are you guys running pretty full right now? Can you explain the logic behind Kaiam acquisition?

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

Sure, Dave. I think what I'd like to do is maybe take a step back, maybe take a minute or 2 and just convey some of our thinking about the VCSEL market in general, and maybe it'll provide a good context for the actions that we have taken. First, I'd like to say that we have a market focus and an individual early-moving customer commitment. The 3D sensing market is coming. It's diverse and it's large. II-VI is willing, able to and supporting



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early adopters and will continue to serve these customers with a long-term deep and intimate commitment. However, we also intend to serve the broad consumer laser market. We have a multiple product and platform focus. Today, we serve multiple markets with material-based technology and synergistic manufacturing capabilities. II-VI intends to serve multiple markets from a platform of assets that can support multiple products. Our Zurich, Warren, Newton fabs together with our Champaign, Illinois epi operations and our greenfield wafer probing center in the Lehigh Valley, Pennsylvania are all good examples of multi-capability operations. As a reminder, we have been a leading materials-based provider to the industrial laser market for a long time. In 2012, we acquired one of the premier management and technical teams and the world-class manufacturing platform is Zurich. This team has designed, developed and manufactured hundreds of millions of VCSELs for the consumer market and edge-emitting lasers for the telecommunications and fiber laser markets. Our recent acquisitions and organic investments are simply building on already strong capabilities. Let me remind you that our important II-VI-wide company strategies are serving customers first, that have -- and offer the chance to have deep long-lasting customer intimacy, which is a hallmark of the company, that we lean into markets and opportunities from a materials orientation, and that in-house and vertically integrated manufacturing platforms are a focus, such that we've always focused on manufacturing excellence as a core competency, allows us to move fast and control our own destiny and the positive effects of this strategy include an ability to develop deep and long-lasting customer intimacy and trust. Our ability to attract and retain a world-class workforce and to efficiently develop leading-edge technologies and products, while protecting our IP and the IP of our customer, achieve sustainable cost and yield differentiation. Dave, these fabs and these technologies take time to incubate. In order for us to be ready for what we believe will be even larger and more rapidly growing markets in the future, we have acquired the Kaiam fab to have a versatile fab, an agile fab for us to be able to develop more than just 3D sensing VCSEL arrays in it. As I mentioned in my comments, we're focused on the widespread compound semiconductor device market for which we are a key innovator. Okay?

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

Got it. And my last question is regarding the initial orders that you got. Is it pretty much from a single customer? Or can you just give us color in terms of your customer mix for that? And how should we think about ASP?

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

Dave, we will not be able to comment on any aspect of the product, including the ASP. I can tell you the orders which we have received for millions are from a single customer, but we are also engaged with an additional more than 10 customers in this marketplace.

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

Got it. And any particular applications, can you disclose that? Or...

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

3D sensing.

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

I meant, the end market. And that will be my last question.

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

Thanks, Dave. I think that's about as much as we can say today.



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

Just for the benefit of everybody on the call. Obviously, since the Q1 revenue is less than Q4, while we do expect to see growth -- to Dave's first question across all our markets. You may want to think about the segments, roughly may be in proportion to what they were in Q4, but again, we're not going to really give guidance by the segment. I also just want to adjust one comment I made about the acquisition. It's probably more in the area of 5% or a little under percent of the new acquisitions combined.

Operator

And our next question comes from the line of Jim Ricchiuti with Needham & Company.

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

Just with respect to the Laser Solutions business. The strength you saw, it sounds like it was pretty much across the board in all geographies, but China in particular, was strong. What are you seeing in terms of the outlook in the September quarter? There has been a lot of strength in industrial. Is that sustainable, particularly given some of the concerns people have about the automotive market?

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

I would say that what we saw starting in last quarter, the third quarter, was really a resumption of industrial activity that we really hadn't seen for a couple of quarters prior that. And while it's always hard to say whether any market strength is sustainable, I would say that we do see quite a number of end markets driving industrial production, as Chuck talked about earlier, including various aspects of micro-machining and other types of products that we are not expecting it to exactly be a fad here. Again, we don't know whether it's sustainable for the whole year, but it looks rather strong to us right now. Chuck, do you want to add anything?

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

No. I think that's great, Mary Jane. Thanks for your question, Jim.

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

Okay. And Chuck, just with respect to silicon carbide, it sounds like this has the potential to be a solid driver for you, looking out over the next couple of years. Is there any color or way we can think about it over the next year? I mean, it sounds like it was a nice contributor in Q4. Is that correct?

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

It sure was. It was a nice contributor all...

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

All year.

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

Q4 and all year.



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

Yes. And is there any reason to think that's going to change? It sounds like you're on a pretty good growth trajectory in that part of the business. And is it fair to say there are multiple drivers?

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

Yes, there are absolutely multiple drivers. In the RF -- so we have basically 2 product families, one is our RF product family for the wireless market. Basically, one driver for that is wireless base station applications. On the power electronics side, there are multiple markets and multiple applications. I think as you look out Jim, one thing I can say, a good part of our investment in capacity expansion in FY '18 will be around this business, both in the U.S., and we will be establishing for the first time a low-cost wafer finishing operation in Asia as part of our expansion. So that's number one. Number two, I think for the next few years, there will be a trend towards designing of this technology. It will take time for the technology to be designed in to other customers, but we are sold out. We're sold out today, that's part of the reason why we're expanding our capacity aggressively to be able to meet additional customer demand. And we believe -- we've been told by our customers that we have either among the best or the best technology for producing low dislocation density silicon carbide substrates in large diameter. And so I think that our market opportunity for the next 1 or 2 years at least is going to be -- we're going to be nip and tuck with capacity. So I'm really excited about it. I think additional adopters will come in. I think this is a long-term -- has the potential to be a long-term bull market for II-VI.

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

Did you say roughly what kind of capacity increase percentage-wise you're talking about?

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

No, we didn't. But it's substantial. It will be enough for us to really, really enjoy more than our double-digit growth rates that we target for the company.

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

And last question, Mary Jane. Any guidance or a way to think about OpEx going forward either R&D, mainly R&D, just given what you've been doing over the past year?

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

Yes, so we've talked a few times in the past about expecting the R&D going forward to be down as a percentage of revenue, maybe 7 to 9 kind of percent of revenue going forward. But I think, as we see the integration of these 2 new acquisitions and frankly, some particular growth that we saw in Q4 of new markets, Chuck just talked about silicon carbide, picking up as -- accelerating, I mean to say. I think it could be between 9% and 10%. With respect to SG&A, we had 2 acquisitions in the quarter, so some of that was obviously transaction cost. I think we will continue to work very, very hard, especially going forward, to try and ensure that from an OpEx point of view, it's at least more geared to engineering than it is to SG&A.

Operator

And our next question comes from the line of Mark Miller with Benchmark Company.



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

In terms of the VCSEL, I believe you mentioned you'll be at full production by end of this quarter, does that mean your fabs are at full capacity?

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

Okay. Good morning, Mark. Thanks for your question. What I said is that I would expect, first of all, that our initial manufacturing ramp that's underway is under the control -- the rate of the shipments are under control of our customer. And I do expect that we could be at the level that he wants us to be by the end of the December quarter.

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

So you also mentioned you were engaged with more than 10 customers, these are for new VCSELS. Do you expect to qualify for any more programs by the end of the year?

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

By the end of the fiscal year, yes. We have that as an objective by the end of the fiscal year.

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

Okay. In terms of the Kaiam fab, are they substantial acquired revenues in the guide?

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

Say that again, Mark.

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

Your acquisition of the Kaiam fab, are there revenues associated with that that you've acquired? Or were the revenues running after -- that unit before you bought it?

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

There were revenues running before we bought it. We do have them. And as I said, I think between the 2 acquisitions, they're probably in the area of about kind of 5%.

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

So that's in your guidance?

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

Right, for both acquisitions combined.



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

So 5% combined. Okay. Finally, just apologize, backlog was -- what was the -- it's \$399 million and it was \$150 million Photonics, \$137 million and a \$102 million for laser?

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

It was \$160 million for Photonics, \$137 million for Performance Products and \$102 million for laser, right.

Operator

And our next question comes from the line of Tim Savageaux with Northland Capital Markets.

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

I do have a question on the Photonics side and really about the optical communications space in general. You did see kind of a book-to-bill below 1 in the quarter and a sequential reduction in orders. And yet you're anecdotal commentary around China was relatively positive. I wondered if you could sort of talk to what you're seeing in China? Whether that translated into some of the order weakness and how you see that heading forward into the September quarter?

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

First of all, Mark, just as a reminder for you and everybody, bookings really can be lumpy. I think, especially as we increasingly in Photonics than very much so across the other 2 segments have long-term contracts agreed at various points in time in the year, they tend to hit the bookings in the quarter that they're achieved. So we talked about that specifically for Photonics related to the Q2 bookings. So as -- just remember that the bookings, generally speaking, are lumpy. I mean, we -- while we obviously look at the book to bill, I think we are really expecting to see continued strength from an optical point of view, especially as we see, as we did in the Q4 period an increasing shift toward Datacom.

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

Thanks for your question, Tim. I would only add maybe just two other things. One is that, year-over-year, we still saw a growth in the fourth quarter for our communications business. That is a sign. Number one. Number two, we have with the team done an extraordinary job of managing both our inventory, our bills and the call logs that we have from our backlog and aligned them with what the customers need. A few of us were in Fuzhou just 2 weeks ago, and especially for example, around our pumps and our passive business, we were in full swing. I reported last quarter that we're running at about 90% capacity on average. I would say that's still the case in the segment itself. But for some of our businesses or some of the lines like pumps and passives, we were just punching them out. And actually, we hit an internal production record in the last week of June for both pumps and passives. And part of that is our confidence in the stability of the demand that we can see even in the near term. So I think, somehow the book to bill ratio is an interesting one, but it doesn't tell the whole story.

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

Okay. Let me follow up on that comment around Datacom strength. And I make sure, I heard what you said properly in the prepared comments. It sounds like you saw a great degree of strength inside the data center. I think this translates into something like 100% sequentially. But please go ahead and confirm that. And I don't know, if you broke out data center interconnect, specifically as a part of metro long-haul. But I wonder if you can comment on any trends there as well? And also whether you expect that rate of growth intra data center to continue? I think you mentioned it was driven by active optical cables at least in part. But it appears you would see Datacom strength as perhaps offsetting any near-term weakness that you might be seeing in China?



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

Okay, Tim. If we take that, I think that's a simple way to think about it. What I said in our -- in my prepared comments was that communications products deployed in metropolitan and long haul network builds, including data center, interconnects, were close to 60% of our sales in the quarter. And what you said is absolutely, true. First of all, on the intra data center business, I think that the big jump that we saw quarter-over-quarter, the biggest contribution to that were VCSELs and PIMs into that specialty application. So I think that we'll see modest growth in that. And the rest of the commentary that -- or at least the information that you fed back is correct. Where we saw a little bit of softness or a little bit of a sideways movement in the core. We did see a pickup in the intra data center products that we're offering to the marketplace. And in some cases, some products that we offer, including our filters, were sold out. And so I want to make a comment that another part of our major capacity expansion as we head into FY '18 will be for filters, both for communications and to establish a strong base for the consumer market as well. Okay?

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

Got it. And final question from me. As you look at the continued extraordinary strength in Performance Products bookings up again pretty solid in the quarter. Is that -- my assumption is that's principally the incremental strength that is driven by silicon carbide in EUV, is that accurate?

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

Okay, Tim. First of all, we -- each of our businesses in Performance Products really knocked it out of the park in the quarter. So that's a combination of silicon carbide and one division of our engineered ceramics for our M Cubed division. And our Marlow division as well experienced some real nice orders this quarter. And then finally, our Military business really knocked it out of the park. And that business, as Mary Jane said about -- in her commentary about lumpiness of bookings, this is a segment that does have lumpy bookings. But it is very nicely covered. In fact, I think at start of the quarter with it extremely strong and maybe the entire quarter was covered for the segment. It's very, very strong, and I expect that, that could continue.

Operator

And our next question comes from the line of Richard Shannon with Craig-Hallum.

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

I guess, my first couple of questions, probably for Mary Jane, more of numbers oriented ones here. So just want to run through on the June quarter revenues. Obviously, you had an acquisition late in the quarter, would the -- was the contribution from that noticeable? Or I guess, what I'm trying to get at is whether the revenues from the base business would have been within the guided range that you gave at the beginning of the quarter?

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

Oh, yes, absolutely for sure. I mean, we -- that they were in the guided range on their own. June -- we acquired on June 19, so it's pretty small. We had immaterial, undetectable effects of the acquisition in Q4.

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

Okay, just want to make sure on that. And then for the September quarter -- for September quarter guide, Mary Jane, I had a couple of questions just earlier on the call about how much the -- how much of the guided revenues are coming from acquisitions? At one point you said 10% and at other one, 5%. Wondering, if you could just clarify that, please.



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

It's closer to 5%.

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

Closer to 5%, okay. Okay, that is helpful. A quick follow-on question on 3D sensing. Chuck, just to verify, the volumes that you're talking about, you used the word the millions, it sounded like more -- it's more volume that would be used for testing and reliability testing purposes. These are actually production or is it going into the end device you'll ship -- you ship to the market, is that accurate?

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

Our understanding is that the multiple orders we received for millions in total are for an initial manufacturing ramp. And even though I didn't say it, I suppose I could have that we also shipped hundreds of thousands of units ahead of that for what I believe was the purpose that you just stated.

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

Okay, perfect. That's very helpful. I guess, a question on the acquisition of the Kaiam fab here. Chuck, can you actually quantitatively or qualitatively suggest how much increased capacities can be both on an equipment basis? And obviously, I know that's a moving target since you've been adding so much in CapEx, but also maybe on a floor space basis as well?

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

Yes, well, let's see. First of all, I'm not going to compare it to our Warren fab, because once I do that, I mean, I'll compare it in a -- at a high level. Once I do that, you'll think -- you may be think, and others may think that the only reason we invested in the Kaiam fab is to support the growth in the 3D sensing VCSEL market. And as I tried to make clear in my commentary Richard, we have the opportunity to expand into the growing compound semiconductor market as part of our long-term growth strategy. The fab itself is substantially larger than the wafer fab that we have in Warren substantially and is very nicely fitted out. But it is not being used today, at the time of the acquisition, to manufacture VCSELS. It is, however, being used to manufacture gallium arsenide RF devices. And the facility itself is extremely well equipped and ready to accept additional equipment of the type that we need for either making VCSELS or for investing in additional devices that I mentioned. It is one of the most remarkable fabs in this compound semiconductor space, I can assure you.

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

Okay. I appreciate that. I have something related with that company, so I kind of know what they were -- what they have there. So it seems like a very interesting purchase there, and I think I understand where you're taking it as well. Let's see, probably one or maybe two more questions left for me. You answered a similar question, but I guess, may be asking more directly on what kind of growth you're expecting from China embedded in the September quarter guidance, both from an optical point of view, but just as a broader China view outside of just optical communications? Any way you can characterize that would be great, please.

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

Well, we don't give the guidance by country either. But I will say that just as we saw some nice growth in the combination of optical and industrial, we -- and we don't think that the industrial trend is necessarily short term. We could continue to see China be strong in our results, but as for an actual number, I don't think I can give you that.

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Operator

(Operator Instructions) Our next question comes from the line of Patrick Newton with Stifel.

Patrick M. Newton - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP and Senior Analyst*

I guess, looking at Laser Solutions' bookings, are the majority of orders for the millions of 3D sensing units you spoke to embedded in the June bookings? Or was the bulk of received -- or bulk of the orders received quarter-to-date?

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

Well, first of all, just speaking about the bookings in Laser Solutions. Chuck gave you a really excellent detailed breakdown of the strength across the whole of the Laser Solutions segment. So it would be probably wrong to say, it was concentrated in any end market. As for bookings, we mostly received them more in the quarter.

Patrick M. Newton - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP and Senior Analyst*

Great. And then Chuck, on the Kaiam side, I believe they also had some 3-inch piece something that was part of the acquisition as well?

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

Well, let's put it this way, the -- it's possible to run less than 6-inch diameter wafers, compound semiconductor wafers through the fab. The fab was built for very large scale integration on 6-inch silicon wafers. And so the tooling and the fixturing and the equipment that's in there is being used for 6-inch gallium arsenide and there is some indium phosphide work that was being done at the time of the acquisition and that was done on substrate diameters that are less than 6-inch. That answer your question, Patrick?

Patrick M. Newton - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP and Senior Analyst*

Yes, that's helpful. And then just last one from me is, Chuck, I think you talked about full production of 3D sensing by the end of the December quarter from kind of a start today. So is it right to think that output yields should improve throughout the December quarter? Meaning, the full potential of output would be more obvious to investors in the March quarter?

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

I'm thinking that output yields, for example, is something that we'll continue to work on forever. So whenever you ask, will the yields improve, that's our job. As far as the initial manufacturing ramp that we believe that's underway with us, as I said, our customer, who is intimate with our capacity and our capability will control the pull from us. And I believe that in the December quarter that it's likely that, that pull will be greater than it is in the September quarter and come to a level that's substantially higher than what it is today. And either level off at that point or depending on their needs and our capacity and capability, may increase from there.



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Operator

And our next question is a follow-up question from the line of Dave Kang with B. Riley.

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

Sure. A couple of questions. Regarding Kaiam acquisition, I believe you said dilution will be approximately \$0.03 to \$0.05 per quarter. How should we think about that going forward? When should we expect that to breakeven or neutral to earnings?

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

Well, we said that we expect it to be EBITDA breakeven by the end of the year. I would say of the dilution we experienced this quarter, probably rounded altogether \$0.01 of it was onetime the inventory step up and acquisition cost. And a lot of how that gets to EPS breakeven depends on how the volume comes through to ramp. So that's why we're not talking about EPS at this point. But I'm very sure that as time moves on here that will become very clear.

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

Got it. And then back to 3D sensing. Can you just talk about gross margin rough estimate, whether 50% over, under?

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

Well, again, we've talked about this for a while, we don't give gross margins by product line. And I think what we have said is that we don't expect it to be dilutive to earnings to the company's average, but that's as much as we can say.

Operator

And our next question is a follow-up question from the line of Mark Miller with Benchmark Company.

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

Just wanted to clarify, you said millions of units were shipping, are these arrays, when you're talking about millions of units or VCSELs, individual VCSELs?

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

Yes, good clarification, Mark. They're VCSEL arrays, millions of units of VCSEL arrays.

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

Okay. And I should know that Military was strong and the Performance Products was strong, can give a little more color on that?



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

Yes, sure. I absolutely can. Let me just try to hit a few of the highlights here. I'm not going to fly over the ground again on silicon carbide. But in our M Cubed division, I mean, we saw a substantial increase in demand for the products that we make for the semiconductor market, driven by demand increases for tools for lithography, inspection, metrology tools, for those equipment suppliers who are supplying in new fabs for DRAM and 3D NAND capability as well as a continued investment in LCD fab construction in China, which we underpinned with some very specialty products from our display glass refractory business. So that's one part. Also, the M Cubed team have really done a great job in the Performance Products group and their continued expansion plans in Asia with a new product line called COGENTUM. This is a line of metal matrix composite materials, which broadens our product offering into the back end of the semiconductor line, in our semiconductor manufacturing process and those related tools, Mark. And at Marlow -- Marlow saw a demand increases both for its personal comfort products and will be launching as many as either 5 or 6 new products into its already large and growing life sciences business. And in the Military market, we received a very large booking -- for a 5-year booking for some very specialized components that we make for the Military for the common missile warning system, and also for certain infrared search and track applications as well. So we just had across the board just, as I said, a grand slam for Performance Products.

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

Just one final thing. Semi was \$98 million of sales previous quarter?

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

Repeat the question, would you please, Mark?

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

Sales related to semi, what were the totals for the quarter, \$98 million?

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

Okay. We'll have to do the arithmetic here; we had a percentage. Mark, we'll get back to you on that, because we're going to run out of time. We'll just to do the math on it, okay? Okay, thanks for your question, Mark.

Operator

And I'm showing no further questions. And I'd like to turn the conference back to Chuck Mattera for any closing remarks.

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

Okay. Well, thank you, Michelle. To conclude our call today, I'd like to do two things. First, I thank all of you who joined the call today, including the 2 new analysts, who have just recently initiated coverage of II-VI as well as other top industry analysts. We're happy to have had all of you today, especially our shareholders also who joined the call. Second, I want to acknowledge all of our employees for over-delivering on our plan with a great enthusiasm and teamwork, a hallmark of II-VI. Thank you also for the speed with which we were able to move to acquire 2 new businesses and helping to deliver, not only a fantastic quarter, but an absolutely fantastic year. I also want to welcome to II-VI our new employees in Integrated Photonics and at the Compound Semiconductor's division that we just announced. Finally, we enter Q1 with a strong backlog, a great deal of momentum and the usual sense of urgency to carry on our profitable growth track for this year, while setting a foundation in place to drive long-term shareholder value. Thank you all again. And let us say, so long, until the next earnings call date slated for Tuesday, October 31, 2017. Mary Jane, do you want to add anything?



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

Sure. Let me just answer Mark's question. Mark, we were talking about it -- if you're talking Q4, \$98 million was the totality of industrial and semicap, just so we didn't kind of roll it all together. We didn't have multiple things to report on. And semiconductor, again if you're talking about Q4, was about 10% of that total.

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

Okay. Thank you, Michelle.

Operator

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

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