Client Id: 77

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IIVI - Q4 2018 II-VI Inc Earnings Call

EVENT DATE/TIME: AUGUST 07, 2018 / 1:00PM GMT

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the II-VI Incorporated FY '18 Fourth Quarter Conference. (Operator Instructions) As a reminder, this conference is being recorded. I would now like to turn the conference to Ms. Mary Jane Raymond, Chief Financial Officer. Ma'am, the floor is yours.

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

Thank you, Ashley, and good morning. I'm Mary Jane Raymond, the Chief Financial Officer here at II-VI Incorporated. Welcome to our fourth quarter and year-end earnings call for fiscal year 2018. With me today on our call is Dr. Chuck Mattera, our President and Chief Executive Officer; Dr. Giovanni Barbarossa, our Chief Technology Officer and the President of our Laser Solutions segment; and Gary Kapusta, our Chief Operating Officer. This call is being recorded on Tuesday, August 7, 2018.

Just as a reminder, any forward-looking statements we may make today during this teleconference are given in the context of today only. We do not undertake any obligation to update these statements to reflect events subsequent to today. With that, let me turn it over to Dr. Chuck Mattera. Chuck?

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

Thank you, Mary Jane, and thank you to everyone who's joining us this morning, including [Cohen & Company], who initiated coverage on II-VI since our last earnings call.

Today, I will give you an overview of our results and our prospects, Gary will focus on our operational initiatives and plans, Giovanni will discuss the key technologies driving our growth and Mary Jane will explain our results and guidance. II-VI had a great ending to a great year. For FY '18,

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our company surpassed the $1 billion revenue mark for the first time in its 47-year history, thanks to strength in every one of our end markets that drove overall top-line growth of 19%. This growth validates that our diversification and differentiation strategies, including deeper customer relationships, investments in technology, product leadership and increasing scale, continue to take hold. The new markets of 3D sensing, EUV lithography and silicon carbide semiconductor substrates drove nearly half of our growth, while the strong demand from the other end-markets was extremely well served by our teams around the world. They worked tirelessly to deliver our results and they set a number of records doing so throughout the year.

For the fourth quarter, revenues grew 17% compared to last year and we set another record for revenue and backlog. The industrial, communications and semiconductor capital equipment end-markets achieved all-time high revenues, and we did not experience any slowdown throughout the quarter from any of these markets.

Collectively, these 3 markets accounted for about 80% of our Q4 revenues. Of our $321 million of revenue in the quarter, the robust industrial market demand was the largest contributor to our year-over-year growth or 62% of our overall growth. Infrared optics sales for CO2 lasers deployed in the materials processing and EUV lithography markets actually grew a solid 20% in the quarter, while components for fiber lasers and direct diode lasers also increased 20% and silicon carbide substrates for power electronics applications grew by 225% as our additional capacity came online to serve the rapidly growing demand.

Our revenue from the communications end-market was strong. Sales to customers in that end-market drove the highest book-to-bill ratio at 1.18, grew revenue 13% sequentially and 11% compared to Q4 of last year, and despite challenging market conditions, we actually ended the year with 6% annual growth.

We saw 20% sequential growth in Datacom, driven by the cloud and ROADM customers. We ended the year with a record backlog, positioning us well, we believe, for an exciting FY '19.

In fact, I'm really excited that the demand from optical communications market accelerated through the quarter and into July, which started the year off with a record monthly bookings. Our revenues to customers in the military market grew 13% for the year, as the military market is in the midst of a number of technology and product transitions involving high power semiconductor lasers and precision optomechanical assemblies. We believe, there is a longer-term trend forming that suggests that the market is moving rapidly towards our platforms, and so we are accelerating investments in this area during FY '19 to meet the growing opportunities.

We can also feel the momentum increase as our sales into semiconductor capital equipment end market grew 10% in the quarter with EUV lithography product revenues growing over 30% in the quarter and a very strong 65% for the year.

We believe that the addressable market for EUV tools over the next 36 months will increase to about $7 billion. EUV lithography component shipments are now about 3% of our revenues and our manufacturing operations at multiple locations that serve this market will have new capacity coming online during FY '19.

Our 3D sensing end-market demand for Q4 was consistent with what we communicated last quarter and with typical consumer electronic seasonality. And we continued to invest significantly in new product development and qualification processes during Q4. The market continues to present us with attractive growth characteristics, market reports from various sources forecast the addressable market for consumer VCSELs to range from $1 billion to $3 billion by 2023. Expanding our market leadership and serving a growing number of end-markets and applications enabled by semiconductor lasers is a priority for the company. As a result, we continue to be engaged in numerous 3D sensing and LiDAR designing efforts aimed at increasing our customer base and driving increased functionality of the end applications.

Turning now to the strategically diversified distribution of our full year FY '18 revenue by end-market; 39% was in communications, including wireless and optical communications; 30% was in industrial; 10% was in military; 8% was in semiconductor capital equipment; and the remainder was in consumer electronics, automotive and life sciences.

Our FY '18 sales were also geographically diverse, 43% in North America, 21% in Europe, 20% in China, 8% in Japan, and 8% for the rest of the world.

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In 2018, we executed well against our market strategies, realized 16% organic growth, broadened our customer relationships, enhanced our product offerings and invested in scale and technology including the acquisition of CoAdna, and I'm excited to welcome the CoAdna team to II-VI around September 1. We closed the year with a record backlog, a number of our manufacturing centers operating at capacity, which we will selectively invest in during FY '19 to meet the anticipated customer demand. We achieved a record cash flow from operations in the last quarter and positive free cash flow after 2 years of investment.

I'm really excited about our prospects and I would like to thank all of our employees around the world, who are well underway, covering the ground quickly in order to deliver another exciting year.

With that, I'd like to turn the call over to Gary to focus on some of these highlights for the quarter. Gary?

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

Yes, thank you, Chuck. Our strategy to target investments in selective growth markets with transformative applications that require our differentiated material platforms has resulted in accelerated growth, much of this from our largest and fastest-growing customers. As one important measure, we ended fiscal year '18 with 26, 2-6 customers contributing over $10 million in annual revenue, a major difference compared to fiscal year '15, when we had 3 customers contributing revenues greater than $10 million. All of these greater than $10 million customers bought products from more than one division or product line, about 2/3 bought from more than one segment and collectively, they account for over 50% of our fiscal year '18 revenue. During fiscal year '18, we did not have any customer that accounted for 10% of our sales. Total customer demand and long-range planning for future demand drove our fiscal year '18 investment of $153 million in capital equipment. We invested $50 million in our compound semiconductor materials and device platforms, initially the main driver for VCSELs, $35 million for CO2 and fiber laser and direct diode laser materials components and subsystems, $27 million for silicon carbide substrate technology and capacity expansion, $18 million for optical communications components, $13 million for the EUV lithography components and $6 million for military materials and precision optical assemblies. Since our end-markets continue to experience strong demand, we expect the fiscal year '19 CapEx to remain in the $140 million to $170 million range to accommodate our anticipated longer-range growth.

We also invested about $3 million during fiscal year '18 to begin the consolidation of some of our global operations to improve efficiencies. With an increasing number of our customers buying components made by multiple product lines across the company, we also continued to unify our global sales force including consolidating the back office function of our customer service operations. The consolidation of our European sales operations into one location enabled us to centralize inventory, improve our customer service, and over time, we expect to reduce our costs to serve and to increase our sales.

We also expanded some of our manufacturing sites in order to consolidate other sites to leverage synergies and improve productivity. This including -- included upgrading systems that allow multiple divisions to operate from one site. We've now done this in the Philippines and Vietnam, and we have work underway for similar outcomes in Fuzhou, China. We continue to examine of our options to make further improvements across the company and are working with urgency to do so.

Finally, regarding our pending acquisition of CoAdna, many of the required steps are completed and we are planning for a September 1 close. CoAdna will be integrated into the Photonics segment. The timing is great, our customers are excited and we believe CoAdna will be a great addition to II-VI. We look forward to being able to satisfy our customers' requirements for more integrated solutions, incorporating wavelength selective switches. With that, I'll turn it over to Giovanni for the rest of our highlights this quarter.

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

Thank you, Gary. 2018 was a great year for several of our engineered material platforms, in which the company has invested for as long as 20 years, as the experience, the growing demand, driven by a number of megatrends. Silicon carbide substrates, CVD diamond optical windows, optical isolator materials, pump lasers and VCSELs were in high demand, enabling a broad range of rapidly growing applications in data center communications, extreme UV lithography, 3D sensing, 5G wireless and electric vehicles.

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During 2018, they contributed significantly to our growth, and we believe they will continue to fuel our growth for many years to come.

Silicon carbide substrates now constitutes 5% of our revenue and are growing rapidly. Silicon carbide semiconductors are in strong demand in high-performance wireless applications due to the thermal efficiency in gallium nitride-based devices.

The demand for silicon carbide semiconductors is even stronger in power electronic applications due to their wide bandgap properties, enabling high electrical power conversion efficiencies in electric vehicles, industrial motor drives and other applications driven by the demand for clean and renewable energy.

In 2018, we expanded many of our manufacturing operations, including synergy diamond, precision metamatics composites and optical components for CO2 lasers, particularly, for extreme UV lithography. This latter category, which grew 65% on an annual basis in 2018, improves the manufacturing efficiency of 7 nanometer nodes and will enable 5 and 3 nanometer process nodes in the future.

VCSELs came into greater prominence this year for their adoption in 3D sensing applications. VCSELs and other compound semiconductor components for Datacom grew nearly 50% sequentially and 66% year-over-year.

VCSELs for 3D sensing and Datacom are now about 5% of our revenue, and we expect this sustained growth driven by data center investment and broader adoption in consumer electronics. Sales of fiber and diode laser components grew 20% in the quarter. The industrial pump laser components, in particular, grew 160% year-over-year as we enable more than 30 fiber laser makers in the world, most of them in China. Our high-power laser beam delivery systems also showed impressive strength with a growth of 40% for our high powered fiber cables.

In communications, the demand for our pump lasers exceeded the supply for the most of the year, even as we continued to increase manufacturing capacity and most of the industry was challenged throughout the year. Our optical isolator materials delivered just over $20 million of revenue for the year from our acquisition of IPI, about 15% above our expectations. These materials are used in optical transceivers to prevent light reflections into the laser. They are also core to optical circulators that enable Datacom transmission over 1 fiber instead of 2, greatly reducing the number of cables in data centers.

Our R&D spending this year increased 21% compared to FY '17 from both organic and inorganic investments. About 60% of the increase came from our recent acquisitions, which added to our capabilities in optical circulators and isolators and the expansion of our 6-inch compound semiconductor device, manufactured in [Glasgow] is our state-of-the-art [fab] in the U.K. We also made significant investments to expand our laser diode portfolio to a broader state of applications beyond 3D sensing in consumer electronics as well as in innovation to increase manufacturing throughput of silicon carbide substrates. With that, let me turn it over to Mary Jane.

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

Thank you, Giovanni, and good morning again. Regarding our press release, you will see that on the first page we show the total company numbers for the quarter and the full year, including an expanded definition of adjusted EPS to include the charges for the Tax Reform Act and the company's subsequent actions, share-based compensation, amortization and one-time M&A costs. The details of these items by financial statement caption are on Table 9 for the quarter and Table 10 for the full year. Then on the second page, we have our standard segment table.

The company's overall gross margin for Q4 was 39.7% and 39.8% overall for the year. The operating margin was 11.9% for the quarter and 11.7% for the year. Operating margins did not improve materially from FY '17 either in the quarter or for the year due largely to about a $2.7 million negative effect of currency on the quarter compared to Q4 FY '17, or about 80 basis points, and $7.3 million negative effect of currency for the whole of FY '18 compared to fiscal year '17, or 60 basis points.

The reported quarterly revenue growth rate in the quarter was 17.3% and the organic growth rate was 15.5%. Regarding the segment operating margins, all segments reported double-digit margins this quarter. Compared to the prior year fourth quarter, Laser Solutions saw the benefit of 3D sensing, EUV and growth in Datacom. Photonics withstood the brunt of the currency impact, reducing their operating margin by about 240 basis

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points. Performance Product operating margin of 11.9% was below last year's high of 15.3% though their last Q4 was exceptionally strong, as we said at the time.

The quarter's backlog of $451 million consists of $163 million in Photonics, $162 million in Performance Products, and $127 million in Laser Solutions. The backlog contains orders that will ship over the next 12 months.

We had $4.4 million in share-based compensation for Q4, a sequential and year-over-year increase due to a rise in the stock price. Annual share-based compensation expense was 17 -- excuse me, $19.7 million compared to the FY '17 total of $16 million and then $12 million for FY '16.

The company had other income of $1 million primarily from equity earnings from our investments. Capital expenditures this quarter were $37 million and $153 million for the year. Our depreciation expense was $19 million in the quarter or about 21% higher than Q4 of FY '17, driven by our capacity and portfolio investments.

With respect to interest and amortization on our convertible debt, Table 7 on Page 4 of the press release lays this out. Because the effect of the convert is slightly anti-dilutive after considering the effect of our equity compensation on the diluted share count, we now do not need to add back any aspect of the convert to the EPS calculation.

The Q4 FY '18 tax rate was 20.6%. This included a reduction to the expense of implementing the Tax Act of $1.3 million. The total impact associated with the Tax Act and the company's related actions was $8 million. Please note that under the SEC guidance for U.S. public companies implementing the new Tax Act, companies have all of calendar year 2018 to finalize their estimates.

For II-VI, now with our full year earnings in hand, we believe we have the majority of the effects of the new act recorded. Excluding this impact in Q4, our tax rate would have been $0.24 -- 24%. We now expect the tax rate for FY '19 to be between 19% and 23%.

The reported EPS in the quarter was $0.42 a share and $0.52 per share on an adjusted basis compared to $0.50 in Q4 of FY '17 and $0.48 on an adjusted basis.

Our EPS this quarter was not materially affected by currency due to hedging and there was about a $0.02 per share tax expense for the change in the mix of the taxable income around the world. Our cash was $247 million and our net debt position is $250 million. We did not repurchase any shares this quarter and still have 31 million remaining on our authorization.

Turning to the outlook. The outlook for the first fiscal quarter ended September 30, 2018, is revenue of $305 million to $315 million, an EPS on a GAAP diluted earnings per share basis of $0.36 to $0.42 including $0.04 cents per CoAdna one-time expenses. We expect CoAdna to be EBITDA breakeven for the quarter and the year. On an adjusted basis, the EPS is $0.54 to $0.60 a share, which includes adding back $0.04 for the one-time cost for CoAdna, as I just said, $0.06 for amortization expense and $0.08 for share based comps, but excluding any refinements to the transition tax as the company monitors any further guidance on the implementation of tax reform. This is all at today's exchange rates and we do not forecast the currencies in this guidance. The weighted average share count is 66 million shares this quarter as the convert is slightly dilutive. We do not need to add back the 7.2 million shares.

For comparison to the prior period, the results of the first quarter ended September 30, 2017, were revenues of [$261.5 million] and GAAP diluted earnings per share of $0.32. This $0.32 EPS includes $0.03 for M&A costs, $0.09 for stock comp and $0.05 for amortization.

Now as we turn to the Q&A for this call, remember that 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.

I'll also remind you that our answers today 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. In addition, during the Q&A, we will continue to abide by all of our customer confidentiality requirements. Ashley, you may open the line for questions.

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Tim Savageaux with Northland Capital Markets.

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

A couple of questions. First, I wonder if you might provide a little bit more color on the strength in Photonics bookings that you provided some additional details on trends in China last quarter, though, I imagine your strength is pretty broad-based here. So as we look at Photonics book-to-bill of 1.18, do we see that's principally driven by optical communications? And are there any kind of product or geographic areas within that, that are worth calling out? And then, I guess, finally, on that, I imagine that would imply sequential growth in revenues on the Photonics side in fiscal Q1 and declines in -- across the rest of your segments where you did see lower book-to-bills below 1.

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

So a couple of things, just to level set. Number one, as you guys will all remember, bookings can be lumpy. So the bookings in the quarter do not necessarily portend exactly the Q1 revenue. The other thing I would just remind you is that the Q1 period is normally the seasonally low period for industrial. So let's just make sure you're all remembering that part. I would say it's probably fair to say that with respect to Photonics, the growth was fairly broad-based. Giovanni, in particular probably told you a little bit here as did Chuck about the growth we're seeing in Datacom, but still, I would still say, across-the-board, we've seen some pretty nice growth in the Photonics segment.

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

If I could follow-up on that, you did announce capacity expansions which you referred to on the call on the amplifier and pump laser side. In terms of the timing of that expansion, does that contribute to revenues in the June quarter? Or will it, for the outlook for September, that increased capacity?

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

I would say that, first of all, because pumps, in particular, are such a vital component broadly based in optical communications, I'd say that the most recent capacity that we just announced is probably not per se affecting Q4. But other capacity expansions that we've done probably are. And it will probably be roughly online in at least the first half of the year. Keep in mind that we -- when we do a capacity expansion, we're not necessarily laying out a whole line. The whole goal is to break bottlenecks.

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

Okay, and then last question for me. Looking at the overall down sequential guide after a strong fiscal Q4, along with the Laser Solutions book-to-bill, that wouldn't seem to imply a big seasonal uptick on the 3D sensing side, but I wonder could you could provide any comments there about what your expectations are for the second half of the calendar year?

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

Well, first of all, again, with respect to Laser Solutions book-to-bill, as we try to remind you that the book-to-bill, which was 1.09 in the Q3 quarter, bookings can be lumpy. I would also say that, again, in some quarters -- in some years Q4 to Q1, we have had as much as $25 million of a difference

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between Q4 and Q1. So I would say, again, it is the seasonally low quarter for industrial, notwithstanding all the great strengths we're seeing in industrial. And I would not necessarily read that as just about 3D sensing at all. Please, Giovanni.

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

Tim, I just want to mention this. We believe that our -- the second half calendar '18 revenue (inaudible) will be higher than the second half calendar '17. And so it would be an upside for us versus last year.

Operator

Our next question comes from Troy Jensen from Piper.

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

I just want to dive a little bit more into the industrial laser business. Especially with the book-to-bill that you just mentioned briefly. It sounds like you guys are extremely upbeat on the EUV business so that was probably, I'd imagine, a book-to-bill above 1 within the segment. 3D sensing we expected to be up. So can you just talk about just the industrial lasers within that? And I'm curious to know if you guys saw any weakness at the end of the quarter given all the trade chat with China here.

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

Okay, this is Chuck. Thanks for your question, Troy. Regarding our commentary, especially about the 20% increase in our sales to fiber laser and direct diode laser makers, we did not experience any slowdown throughout the quarter. We had a strong demand. Giovanni mentioned in his comments, we're serving today, 30 solid fiber laser makers around the world. And our portfolio of both optical components, laser components, beam delivery systems, cables, I mean, we are a full-line supplier. And more and more people are coming into the marketplace it seems and our value proposition is really a real good fit for those kinds of companies. So I would say it was just a solid -- overall solid quarter. And it was a solid and steady quarter. Okay?

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

Okay, that's fair. Giovanni, could you repeat some of the growth rates that you said for the consumer VCSEL business. I apologize if I missed them.

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

I didn't mention any number. I just said in the second half of the calendar '18 we'll have higher revenue than in the second half of the calendar '17. So consistent with our communications in the previous quarter, last quarter or 2 quarters ago, we see that has been the case. So we anticipate higher revenue than last year -- last calendar year in this second half of the coming year.

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

It's also probably fair to say that we exit Q4 here with the highest laser utilization that we've seen in the last 5 years. And if you all will remember, it -- since we sell products as well into the aftermarket, the laser utilization is very important.

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

Understood. Mary Jane, one last for you. Can you give us, I know you will -- I think you will during the quarter but the Laser Solutions sales both in the life science and consumer bucket?

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

Yes. So we will put forward the chart clip for you for sure. But with respect to Laser Solutions in life sciences, automotive consumers, all those kind of small ones, they're probably in the neighborhood of about, I'd say, $25 million or $30 million.

Operator

Our next question comes from the line of Meta Marshall from Morgan Stanley.

Meta A. Marshall - *Morgan Stanley, Research Division - VP*

Two questions for you. One, the Datacom results kind of seem to be a significant step up. And so I just wanted to get a sense of, is there lumpiness to that market? Or there was a kind of order based uptick that we could have seen this quarter that may not follow through to next quarter, are you kind of seeing an inflection there? And then second question, you mentioned all the areas where you're investing in. Are there certain -- without divulging kind of what exactly you're capacity constrained on, can you give us a sense of maybe what categories you're capacity constrained on today?

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

Good morning, Meta, this is Chuck. I'll take the Datacom and -- let's take that one first. I think that best thing we can say -- the best thing we can do is look backward. And what I can tell you is that for the way in which we segmented the market and aligned our product portfolio, comparing to the same quarter last year, then we experienced 80% growth. And I was comparing it to the prior quarter meaning Q3 of this year, we experienced a 21% growth. And over the last 4 quarters, it hasn't been lumpy. It's been up and to the right. And we're working really, really hard to position ourselves with an increasing number of customers, a broader portfolio of products. And I won't be satisfied even if the markets lumpy, I'm expecting to win a greater amount of share.

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

And then with respect to the part of your question about capacity constraint, I'd say probably, silicon carbide and EUV are probably the most capacity constrained as we go forward. But Gary and I both talked about what we think the capital will be here. I think -- we will be watching this as the year goes along. And as I mentioned, earlier, our goal in capacity expansion is to break bottlenecks and so we do that on an almost continuous basis.

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

Let me just add to that because I think Tim was asking about capacity as well. EUV, for sure, silicon carbide for sure, as Mary Jane said. Our communications market, for sure, both in the passive component for thin film filters and around pumps and amplifiers, channel monitors, tunable filters, the whole suite of products that underpin the growth in the DCI market, the cloud, the driving increases in the cloud and the ROADM deployments, we have a -- almost a symphony of constraints that we need to manage, and we're managing them carefully, deliberately and absolutely with a great sense of urgency, so we quantify the investments to be sure that those investments are balanced and keeping pace with what our customer requires of us. And as you heard from the rest of the narrative, it's been stepping up here in the last 3 or 4 months, and we're stepping up our game at the same time.

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Operator

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

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

Quick question on the guide. Just to make sure -- I don't think you specified, but I just want to make sure that you're not including CoAdna in the sales guidance in the September quarter? Is that correct or are you including it?

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

No, it's very immaterial. It's not even going to come in until the 1st of September.

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

Okay, just want to make sure, that's good, thank you. Second question on 3D sensing. Chuck, I think I recall you saying in the last quarter you expected substantial growth in VCSEL rates for 3D sensing in the calendar second half over the first half. I don't think I heard you reiterate that commentary. So I just want to make sure -- I guess, just get your latest thoughts on what you're expecting from 3D sensing in the second half of the year?

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

Sure, I'll give it to you this way. I'm going to give it to you qualitatively. But, in Giovanni's comments, he answered Tim's question, I think, by comparing our anticipated second half of this calendar year to the second half of the last calendar year. Your question is whether or not we're on track to where we thought we would be 90 days ago with the second half of this calendar year being higher than the first half of the calendar year. And I can tell you substantially. Second half this calendar -- the first half of this calendar year, I expect we'll be up.

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

Okay, I guess, just in the context of again kind of following up on a couple of previous question about your book-to-bill in the Laser Solutions business being a little bit below 1 in your commentary about industry lasers being, I guess, solid, yet seasonally down. I'm just trying to balance those two out and see why the book-to-bill was down if both of them looked to be progressing well here. Any clarity you can offer on that, Chuck, would be great.

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

I think the best I can say is that the bookings in some of these markets, including in the emerging markets, can be lumpy. And we've seen them be lumpy. So that's our best view today as we look out -- we've given guidance for the first quarter. But now, you're asking full (inaudible) to the full rest of this calendar year. And it's my best view today with all the facts that we have that we will be considerably higher in the second half of the year than what we were in the first half of the year. That's what I'm expecting and that's what we're driving to, Richard.

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

Okay, fair enough. I'll ask 1 question and jump out of line. CapEx. Did I catch the number correctly of $140 million to $170 million for fiscal '19? And whatever the number is, can you give us just a sense of any priorities you have for that CapEx, especially if they are changing over fiscal '18?

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

Yes, Richard, it's Gary. Yes, you had the number correct. We're targeting $140 million to $170 million in CapEx for the year. Priorities will vary as we begin to get more clarity from our customers and lock in some of our longer-term agreements with them. But clearly, the areas that Chuck talked about earlier in terms of industrial, EUV, Diamond, silicon carbide, Photonics pumps and amplifiers, at the top of the list. Also, we'll have some capacity expansions, really, in all of our divisions across-the-board, but at a much smaller level as we see growth really in all of our end markets.

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

I would add to that, that among our filters are, especially at the early start of the baseball game that we're in, any revenue, profit and cash and then -- as part of our service to our customers -- and then a roadmap to be able to expand our capacity and capability to be able to enable the broad-based service to all of our customers, and at the same time be able to make money. That's what we're after.

Operator

Our next question comes from James Kisner with Loop Capital Markets.

James Martin Kisner - *Loop Capital Markets LLC, Research Division - SVP*

I was hoping you can give us, I know you don't really guide OpEx or gross margin, but I was hoping you can maybe give us a little direction. Obviously, EPS guide is well above The Street and the revenue not near as -- not so much. I'm just trying to understand within that where you're expecting your gross margin? Are you expecting a pretty good improvement sequentially in OpEx as well? And maybe you could also just, again, touch on the share count and a contributing of the convert that you're anticipating in this coming quarter -- September quarter -- is it 365 million shares or we should be doing a converted test or adding back the interest? Can you just kind of quickly go through that?

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

Right. Okay. So first of all, let me do the last question first. So as I said, the way that the calculation goes to deal with the convert, it goes in order. First, you add back your share-based compensation and then you look at the effects of the convert. The convert is now for us, a little bit anti-dilutive. So no, we do not add back the interest and amortization and you do not add the 7.3 million shares. So you would use the 66 million shares to calculate the EPS. So that's the first thing. I think the second thing is, with respect to margin, we are not changing the margin range that we had out for 2018. And we'll hold it at the gross margin of 38.5 to 41, op margin 11 to 13 and EBITDA margin 18.5 to 21 and be working to move to top end of that range. So I think, the way you want to think about it is -- then with respect to OpEx is -- Gary spent a good amount of time talking about the work that we are doing to try and corral the OpEx to consolidate our operations now that we, generally speaking, have at least one or more in pretty much every country we operate. It's now -- kind of at the size now where it's are ripe for some consolidation. Just efficiencies and things, where I think it will actually be easier on our employees too. So that will be underway. I don't know that there is necessarily a significant downturn in the OpEx. I think, it may be, perhaps, on the way share count is being used or the way the tax rate might have been calculated. I can't really explain. But I'd say, generally speaking, we shouldn't see a market change just in one single quarter. But I would say we continue to be very, very focused on the OpEx management.

James Martin Kisner - *Loop Capital Markets LLC, Research Division - SVP*

Okay, that helps. I don't think you answered this directly, you said you thought 3D sensing was going to up in the second half year-over-year. Can you talk about linearity in efficiency revenue? Do you expect that Q4 -- calendar Q4 to be bigger than calendar Q3, for example, I'm just trying to get a sense.

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

James, can you repeat that question. I didn't really understand the last part?

James Martin Kisner - *Loop Capital Markets LLC, Research Division - SVP*

I think you didn't -- I'm not sure if you commented on the sort of calendar Q3 -- fiscal Q -- the September quarter outlook for 3D sensing. I know you gave the second half outlook for 3D sensing. But I was just trying to understand the linearity or the sort of -- are you expecting 3D sensing to ramp in calendar Q3 and then, again, in calendar Q4 or are you willing to give a little bit more granularity on the 3D sensing outlook?

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

I think we have about as much as we can give and extended it out to the second half of the year. I wouldn't feel comfortable to give any more granularity, James.

James Martin Kisner - *Loop Capital Markets LLC, Research Division - SVP*

Okay. Just last one. I think you said Photonics operating margin was down 240 bps year-over-year driven by ForEx. If I heard that right, I note that it was down, I think 275 sequentially. Is that also ForEx or is there another reason why operating margin in Photonics was down so much sequentially, just wanted to clarify that?

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

You are asking about the operating margins for Photonics, is it mostly due to currency?

James Martin Kisner - *Loop Capital Markets LLC, Research Division - SVP*

Yes, the sequential change. I think you made a comment about the year-over-year change but it was down sequentially, I think, if I got the math right, 275 basis points, just wanted to understand what was driving that?

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

Yes, it still is currency. I think we've seen a particular hit this year from the R&D.

Operator

Our next question comes from Dave Kang from B. Reilly.

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

The first question, and I apologize if it's been addressed already since I joined a little bit late but just wanted for you to go over some of the assumptions for your fiscal first quarter revenue outlook. Looks like the midpoint revenue will decline about $11 million, what's driving that? Is it mostly industrial laser? And you talked about, Mary Jane, you talked about seasonality, but what about some of the stuff like IPG talking about some pause from Chinese and European customers due to macro-related uncertainties?

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

Right. Well, so let's talk about laser uses in general. I think Q4, first of all, is our year-end and as many of you know, part of what drives that is the implementation of lasers for various industrial applications that tend to be done in that June 30 quarter and the summer is kind of light. Having said that, in the quarter ended June 30, we saw, as I mentioned, the highest laser utilization around the world that we've seen in the last 5 years. So we continue to see that market fairly strong. I would also say that while we've seen some industry reports, just keep in mind, we are a components manufacturer. We are not necessarily tied to any one single maker of a laser system. We don't make the laser systems. And increasingly, we've had customers, as Giovanni discussed, on a number of fiber laser companies that we're serving, demanding components. So we continue to see it very strong. I would also just note that for our two largest industrial divisions, their book-to-bill -- just those divisions individually -- fell between Q3 and Q4. So it normally does, because in order to have most of the revenue achieved in Q4, you'll see those bookings in the Q3 and the Q2 period. The Q2 book-to-bill, which I appreciate is not in the press release, is actually higher than it was even in Q3. So I just need to make sure you're all clear that what is the prior quarter's booking is not exactly what's driving the next quarter's revenue. And I think we see the exact pattern that we expected in industrial to see lower bookings in Q4 in anticipation of, generally speaking, the first half of the year being somewhat slower than the second.

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

Let me just add to that, if I could, Mary Jane. And Dave, thanks for your question. As you know, our June quarter is -- has been historically, our best quarter, even when the company was smaller and less diversified than it is today. And we had a great quarter in the fourth quarter. And even at that, we ran overheated, a little bit harder and a little bit faster than what we thought when we started the quarter. And so the September quarter, historically, has been a little bit less busy for us than the prior quarter. And it's our judgment, that's why we put it this way that's what we're going to do and we're going to aim to meet it or beat it. That's where we're at.

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Right. And then just sticking with fiscal first quarter assumptions, I mean, can we assume that photonics and performance will be either flat to up? And then obviously, lasers including 3DS will be down? Is that a fair assumption?

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

We are not going to be able to give guidance either by segment or by product line.

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

But for sure, you just asked is 3D sensing down. I don't think that what's Chuck and Giovanni just said.

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

Yes.

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Just wanted to hear that from you guys. Speaking of 3DS, since you said second half will be stronger than first half. Can we assume that your Kaiam facility will go into production in second half as your East coast facility is pretty much getting filled up?

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

Let's say we have a lot of activity going on, but I'm not prepared to comment about timing of qualification of various product lines that we have in the U.K.

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Okay, fair enough. And then on Datacom strength, what are some key products because you've been saying that you sell mostly ROADM related parts and I'm not sure they are really used in the Datacom network. So what are some key products in the Datacom that's doing well? And is it really highly concentrated? Or it's fairly broad strength within your Datacom customers?

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

Hi, Dave, this is Giovanni. Thanks for the question. You're right. We were not referring to ROADM or anything related to [wavelength] management for Datacom for sure. So part of -- remember we have a high-speed VCSEL platform from 10G to 14G to 25G, as well as the number of passage that go into the -- directly into the data center and into the transceivers for data center application. So between the lasers and the photodiodes and the high-speed laser and the high-speed photodiodes (inaudible) to talk about different filters [max to maxes] so those altogether being pretty strong. The fastest growth has being on the high-speed VCSELs. We won major design wins that basically were deployed in large data centers in China. And those drove the sequential growth that you're seeing. So 50% sequentially and 6% year-over-year. And as you know, those are much higher than the growth rate of the market, right? So clearly, we are gaining share. And one other component, as I mentioned, in my part of the call that the -- that the significant component, which has been driving the Datacom business for -- are the combination of (inaudible), isolators and circulators particularly. As I mentioned, there is a broad use of circulators to reduce the number of fibers in the data center, all right? So that also was a very important growth engine for the Datacom market for us.

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Got it. Just a couple of more, sticking with Datacom. Your Datacom module suppliers, they have been talking about significant pricing pressure. How is the pricing environment for components such as Datacom lasers? And the second question is on EV -- not EV, but EUV. Who are your main competitors? And what's your expected market share? That'll be it for me.

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

Yes, so the [ASP], we have the most practical integrated supply chain, for example, for circulators. You'll recall that we -- we acquired Integrated Photonics, which is only one of the two makers in the world of (inaudible) that going to the circulators. So we have a very, very good cost structure. We don't really see a speed decline as fast as maybe some people may think. So it's actually pretty good. There is -- we understand there is a scarcity of especially good 25G VCSELs. So that's number one. And the same for circulators. We think it's pretty steady. Regarding your question on EUV, we are sole-sourced in -- I would say, I don't know the exact number, I would say probably 90% of our supply into the EUV supply chain, is basically sole sourced. As you know, we make diamond windows. We have a provider in diamond growth reactors. And we understand that's a sole-source product where -- there is a lot of -- (inaudible) then other types of products that go into CO2 lasers, which we believe were also sole-sourced. And there are other components, which I can't disclose that are also sole-sourced. So overall, I think we are in a very strong position deriving from years and years of investment in very strong and differentiated platforms that pretty much nobody can compete with.

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

Go ahead, Chuck. The one thing I will say, Dave, just to answer your question a little bit on performance products kind of year-over-year. As Chuck said, not giving guidance, necessarily, on the segments, but I think if you do look at '17 to '18 -- Q4 of '17 to Q1 of '18 you'll see that performance

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products also tends to go down a little bit in the first quarter. So the slower summer period doesn't just affect -- it affects industrial applications also that are certainly our performance products, so just to keep that in mind. I think that's all your questions.

Operator

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

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

Just 2 quick questions. And I don't know if it's worth noting, you provided some color on bookings in the Photonics market in July. Is it worth noting what the industrial bookings activity was in July? Or is it just too seasonal, Chuck, to really highlight it?

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

No, I don't have any comment about July. It's really the first time that I step into it. So it's just that it ran right into -- from the fourth quarter. It was worth noting.

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

I think it's fair to say though that industrial is very seasonal through this first quarter. Month-to-month is not necessarily an indicator.

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

Fair enough. And then Mary Jane, just last question for me is just with respect to the gross margin range that you are targeting, I'm just wondering, given where the gross margins have been the last 2 years, what are the puts and takes that might impact margins on the downside that we need to think about, because the range, if I heard you correctly, is 38.5% to 41%?

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

Right. So I think, first of all, sometimes, I think we give a range for the year and then we're looking for it every single quarter. So just trying to provide what might be a range if you're looking at it quarter-by-quarter, not that I'm saying that about any single quarter. I think currency is a big issue. Obviously, the hedge that we do on the company is all in non-op income. So it's not necessarily hedged at the gross margin level, that's the first thing. The second thing is, what we kind of talked about, I think, maybe in the 3/31 call or maybe in the 12/31, which is the rate at which the company is growing is causing it to be installing new capacity in a lot of places. And contrary to what I think people maybe thought that somehow there was a lot of idle capacity standing around, that is not the issue. The issue is, the activity level and the resources required to get the capacity in at the same time we are trying to expand it. So I think that's another area. Obviously, AFPs can move. We have some markets that are very, very AFP sensitive and you all know which ones they are. And I'd, obviously, market variation. So those are probably the main things we are watching at the present moment that I'd say could potentially affect the margin.

Operator

Our next question comes from Mark Miller from The Benchmark Company.

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

China sales, what percent is China sales -- were from China last quarter. 20%, roughly?

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

So for the quarter, China sales were actually 20% for the year overall.

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

And 23% for the quarter, okay. I see. Have you seen any changes in the China situation recently?

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

Well, we continue to be busy there, that's for sure if that's what you mean in particular. Well demanded by customers, expansion of work with customers.

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

So no fallout from geopolitical issues?

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

Not that we've seen so far. Obviously, that's something that's on everybody's mind in the industry in general, and we're watching that carefully. But not so far.

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

The only one we're affected by is ZTE, but that's the only one and we're back in business.

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

Okay. In terms of the silicon carbide, did your sales for electric vehicles exceed the Telecom sales in that space again?

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

Yes. EV was above Wireless, yes.

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

And when do you see the ramp really coming from 5G, is that still 6-months, a year out? Or is that just starting to occur?

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

I think some initial system deployments will start. We'll hear about them this year. But I really think it's '19 and '20 time mark.

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

Okay, and then you said you had record cash from operations. I don't believe I got that, cash flow from operations.

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

So right, so the cash flow from operations is on, let me see here, Table -- Page 9 of the press release. So the cash flow from operations for the year was $161 million and for the quarter it was $36 million. 36% up -- sorry, 36% up.

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

It was 36% up year-over-year or sequentially?

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

Mark, can you repeat the question?

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

Was it up 36% sequentially year-over-year, cash flow from operations?

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

Year-over-year.

Operator

Our next question comes from Paul Silverstein of Cowen and Company.

Paul Jonas Silverstein - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

My specific questions have been answered. But let me ask you a general broad question. Given the broad-based strength throughout your business, what are risks that could potentially derail the momentum? What are you worried most about? And what can you do or are you doing to address them?

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

Well, prioritization is becoming an art form in this company. I think the number of things we have to invest in, the number of areas where our materials are not being demanded but -- and engineered material is important. It makes the amount of things we could be focusing on almost limitless. So that's probably number one. I think number 2 is, we just indicated earlier, observing the geopolitical environment is really important. We -- there's certainly a lot of different kinds of activities going on whether that's on individual customers or trades or tariffs or whatever. I think we're watching that very, very carefully. I mean, our company is a global company. We operate and have colleagues around the world. They are important to us. And the customers in those countries are important to us. So we look forward to seeing a little bit of easing of concern there. But for sure, we are monitoring that. Those are probably, I'd say, the main things at the high level.

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I think we're out of time, actually.

Operator

And in that case, I would like to turn the conference back to Ms. Mary Jane Raymond for closing remarks.

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

Thank you, Ashley. This ends our call today. We look forward to updating you on the results of our first fiscal quarter of FY '19, on the conference call now scheduled for Thursday, November 1, 2018, at 9:00 in the morning. We thank you all for joining us. Great Q&A. Sorry we ran out of time, and look forward to seeing you as we resume our Investor Relations activities. Take care, and have a good day.

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

Thank you very much. Thank you.

Operator

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

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