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IIVI - II-VI Inc at Barclays Global Technology, Media and
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CORPORATE PARTICIPANTS

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

CONFERENCE CALL PARTICIPANTS

Joseph Eric Wolf *Barclays Bank PLC, Research Division - MD & Head of Equity Research*

Thomas James O'Malley *Barclays Bank PLC, Research Division - Research Analyst*

PRESENTATION

Thomas James O'Malley - *Barclays Bank PLC, Research Division - Research Analyst*

Great. So I'm Tom O'Malley with the U.S. semiconductors team here at Barclays. And pleased to have Giovanni Barbarossa, the President of the Laser Solution and CTO at II-VI. I think just a helpful start. Giovanni's going to go through some slides, kind of some of the broader topics and then after he's done, we can jump into a couple of questions.

Giovanni, you're up.

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

Yes, thank you. Thanks for having us for the conference. I will stand up, and I'm not going to go through all of the 35 slides that we have. So I'm going to lose count, go fast.

I will start with an introduction about II-VI, Slide #4. This is what II-VI is. It's a pretty diversified company. You can see our footprint in the different geographies in different markets and then the way we organized at the middle where we have the 3 segments, and we'll recharge the portable segments called the Photonics. It's a solution of performance products. The footprint from a market standpoint is primarily in optical communications. Then, the second largest market is industrial and then military and semicap equipment. The market which we are growing faster is growing faster than anybody else is the consumer which shows into the other market on this slide. We have 11,000 -- almost 12,000 employees worldwide. And we have a run rate of about \$300 million, \$314 million in Q3 of last -- the first quarter of the fiscal year. So a run rate at around, for the 3, \$1.2 billion per year. These are the core markets, as I said, optical communications, industrial and military and the emerging markets, the new growth market for us, particularly the extreme UV lithography, we call it semicap equipment. But one area of semicap equipment, which is growing pretty fast for us is the UV lithography part. Then, the silicon carbide for both power electronics and RF electronics in electric vehicle and the 4G, 5G and then the 3D Sensing.

This is the history of the company, so we've been growing very nicely over time. I joined the company in 2012. And the company has a very good track record of profitability and never been at a loss in any year. And we have always been focusing on technology platforms during the acquisition. This is what the summary of all the acquisition that's brought to the company, the various acquisition, the technology platforms, the acquisition part of the company over time.

I want this as -- this is a very important slide because I know a lot of people this morning in the one-on-ones asked about this Finisar deal and how it's going to play out. One thing I wanted to -- this is the first time that we disclosed these numbers. When we acquired the deal, Oclaro business in 2015 -- between September and December 2015, we had a very not so positive reaction from the market because we acquired 2 money-losing businesses. But we -- in fact, as you can see here, the businesses were negative 45% operating margin, and it was a large deal for us. It was almost bringing to the table, almost 50% of the combined company revenue at that time. And so it was a pretty large deal. Over time, we have -- first, obviously, the structural and then eventually, turn around the business. And now we are -- the past fiscal quarter, we are at a 42% operating margin. So we did a very great job turning around the business, and it kind of gives a little bit of an idea of the capability of the cultural and the management team of II-VI in improving the fundamentals of businesses which we acquire.



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So these are a few slides about the acquisition of Finisar, which we announced on November 9. So the combined pro forma revenue would be \$2.9 billion, very strong with the pro forma EBITDA of \$570 million.

The -- there is no doubt that the combination will shift the presence market-wise of II-VI in terms of the distribution of the market presence. Today, we are, as I said earlier 40% in optical communications. The combination with Finisar will shift that to 70%.

And so a lot of our shareholders are kind of asking what does it really mean long term. Is that kind of a market ratio that you will maintain over time? And -- well, I know that's an -- it's an important question but the most important question is, what can you do to improve eventually the fundamentals of the business, given the Finisar gross margins, for example, are substantially lower than our gross margins? What can you do to combine the 2 companies successfully?

We think that the -- it was -- timing was very important. The strategic -- we'll see in this slide, Slide #10, the strategic window of opportunity's now. We believe there is an inflection point in a number of the megatrends that we follow with our business, whether it's electric vehicle, whether it's 3D Sensing, whether it's, generally speaking, optical connectivity. So the proliferation of cloud services and increased data and video compression, this is a point in time where you had to strengthen your position and set the market. And I think Finisar brings to II-VI in the combination an incredible set of technology platforms that will help us just being a much stronger role in the -- all of these markets that you see here. From Datacom transmission or the -- transmission to hold up 3D Sensing and LiDAR, RF electronics and power electronics.

Then -- okay, here we go. Here's the summary or the strategic rationale. The -- I want to go quickly through -- I will move through this slide, this is the more important one on Page 15 because this is a -- it's a slide that summarizes some kind of things that, clearly, were attractive to us. And we can now -- currently, it made us conclude that it was a very good deal for us and for our investors. And they typically don't surface on -- at the visible level to Finisar investors or even other investors. So we kind of put together a slide to kind of explain what's behind Finisar that we really like. And as you know, II-VI has been investing over the past several years in Compound Semiconductors. We have been investing in gallium arsenide. We've been investing in silicon carbide. We've been investing in gallium nitride and silicon carbide, and silicon carbide and selenium carbide. And one platform which we are missing is indium phosphide. We think indium phosphide is a very powerful platform, not only in optical communications, if you think about i-SAFE, LiDARs, even if you think about some high speed circuitry, it's a part from which we don't have. I mean, I -- we believe this Finisar platform is second to none, it's really a great platform. But Finisar never really leveraged it outside of the captive needs. And the other one is the gallium arsenide platform, which is complementary to our gallium arsenide platform in terms of the products that Finisar offers. For example, in terms of edge-emitters, EMLs and the like that we don't have. The other thing which the other complementary, the -- it's another portfolio-filling platform is the high port count, wavelength selective switch platform. We've acquired the preacquisition, which we announced last September. We brought into II-VI the low port count, WSS platform. But in some applications, a high port count is a very critical technology, substantially different. Finisar is a leader there. So we think by combining the CoAdna and the Finisar parts on, we'll have the full offering for something which is going to ramp quickly if -- driven by, of course, data center growth as well as the 5G infrastructure. And then there's also a nice design team in Finisar for integrated circuits, so something we don't have at II-VI. And we believe that it's going to be very helpful to -- for our desires to grow in the Compound Semiconductor electronics generally speaking market.

These are the irreversible megatrends, which we'll -- we're really addressing as a company, so we think we'd be able to address even from a strongest standpoint with a combination of Finisar. If you really think about it, these are really the -- at the core of the growth that we have seen in II-VI over the past few years, and we think the combination with Finisar will just strengthen that growth.

And then maybe I'll go through these slides. These are kind of a -- explains what the footprint of the combined company would be on 5G. 5G is coming, will be big, will be pervasive and there's a lot of hard work that would be required to make that network happening. And if you look at our portfolio, which is primarily on wavelength management and regeneration and then you look at Finisar portfolio, which is primarily on transmission. The 2 combined are pretty much covered in the whole spectrum of optical communications needs that would support the 5G growth. And of course, we -- that's on the wireline side. And then on the wireless side, we'll participate with our silicon carbide platform. And you've heard about the deal we made with this partnership, we made with Sumitomo on gallium nitride and silicon carbide. We'd be able to address also the 5G RF needs in the cell tower, in the base station.



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Let's see because we talk about this. The other one, of course, silicon carbide is still very strong, even if power electronics is not the major market today for the -- our silicon carbide platform. It will be eventually over time, but RF -- power RF is still -- there's no middle market for us, and this is moving very, very fast.

Let's see. Maybe this is the -- a good slide. We're doing the announcement of the deal, we reported about \$150 million of synergies for the deal. This is the breakdown. There's also -- we believe there are synergies in revenue. We didn't really talk about those but we -- there are revenue synergies that will come out from a number of directions in optical communications, in 3D Sensing, and we'll be on top of the -- this -- the cost synergies on about -- the cost synergies really.

And then, let's see, we're going very fast. These are CFO slides, so I want to -- not to comment on these, but basically the idea is to decrease the leverage for 4.1 to less than 2.5 in about a couple of years. So we think that this is a very, very fast accretive deal for us, and it would be good for our shareholders over time.

And then, yes, I think of the core markets. The core markets which are unrelated to the deal, I will spend just 1 minute or 2 to talk about those. Maybe another 2 minutes. The industrial material processing, still strong market for us. We are pretty much in almost -- at any level, we sell chips. So we sell complete systems like the one you see here in the picture, which is welding all Mustangs, all F-150 trucks and the list of cars, and it's pretty long, that we support with our tools.

And then, in the military, it's also based on market where we see a very good opportunity to support our optics, for our optical subsystems as well as our laser engines.

Okay. There -- this would be the way -- you can see the presence of the 3 segments. I'm the CTO, I'm also the President of the Laser Solutions segment, so the -- my biggest market in my segment is industrial. The largest market for photonics is in the communications. And the largest market for performance part is military. And this is the way -- then life science is kind of a small for the entire company's about -- life science, consumer now is about 10%. As I said, consumer will keep growing, probably will double pretty soon in terms of -- with relative terms of the company total.

And then, it's the same slide. So we affirm the guidance that we gave for the current quarter. We believe that things are going pretty well, with no change to what we said during the last conference call. And that's it. So we can go through quick Q&A.

Thomas James O'Malley - Barclays Bank PLC, Research Division - Research Analyst

Yes. Well, we're off to questions now. Well, thank you for the presentation. And thanks for being here with us.

QUESTIONS AND ANSWERS

Thomas James O'Malley - Barclays Bank PLC, Research Division - Research Analyst

I guess you touched on a [variant] there. You showed some core markets, industrial, opti-comms and military. And you've obviously showed that you're going to -- you expect some growth in those. Where do you -- where are you most excited in those core businesses for 2019? And where do you expect to see some of that growth?

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

Yes. So for sure, silicon carbide is a great opportunity for us. We are sold out -- we've been sold out almost every year. And we'll keep investing in process improvements and yield improvements and other things which don't require capital. But on the other hand, we also need the capital to improve -- to increase our capacity. So I've -- again, the RF power -- the RF -- the power RF is still a very good opportunity boosted by the move to 5G. And then EV, for sure, will drive -- continue to drive the demand and will over time, overtake that. EUV is going very well. Demand for EUV parts

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that go into EUV systems is growing and will continue to be a growth engine for the company. Industrial, generally speaking, is still very good, especially in China, but there is a start -- maybe our strongest was last year. But I think, generally speaking, it's still growing. We think that in the optical communication market, particularly, not all customers but there are a few customers which are doing extremely well, and we are very well positioned with those customers, particularly in new wins in India, for example. There's a lot of really new opportunities that we have not had just a few months ago. And then military, we are -- our military team is really growing also pretty nicely. The ratio should -- the ratio -- if you look at our ratio of military revenue over time, over the past few quarters kind of changed a little bit and increased because their business is also growing nicely.

Thomas James O'Malley - Barclays Bank PLC, Research Division - Research Analyst

Great. So I guess, taking a step back -- I mean, we've talked about this before. There's, obviously, a lot of moving pieces going on in China right now, and I think investors get confused about what's tariff-related versus what's customer-specific problems, especially in the fiber laser business. Can you just walk through what's going on there? What are the moving parts? And how -- what does that impact on your business because I know it's different than what you're seeing with some other guys?

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

Yes. I mean, the reality is that the targets are a very good excuse for companies that are losing share. I mean, whenever you have a problem and say, "Well, it must be the targets," it's like an alibi for your problems. I don't know why. We -- in our case, we are -- we don't really see that. And I guess, it's for several reasons. One is some of our customers are gaining share and maybe that's offset some of it, maybe some of these market or microeconomics challenges. Sometime we sell more than we used to sell in terms of real product and maybe we're going to offer it earlier. And so generally speaking, I think the -- where we see other companies' reporting, we are kind of a little bit surprised because, to be honest, the -- our -- the -- I don't know the exact number, you can ask our CFO the exact number, but I don't believe the -- there's been any impact -- material impact to our business from a tariff standpoint or this kind of Chinese-driven kind of dynamics. We don't -- we haven't seen it at all. And this is not only in industrial, it's also true in communications, in anything. So some of the -- that matters when the ZTE, it was banned, it gained -- all JV is a problem. The telecom, the service providers will keep buying OEM systems. If they don't buy it from ZTE, we'd would buy from someone else. So we'll sell to someone else. I -- sometimes everyone -- the reactions of the market to some announcements is pretty counterintuitive because the total addressable market is still the same even if there's one player that cannot play like ZTE because it's been banned, we can still sell to others and the demand will keep going.

Thomas James O'Malley - Barclays Bank PLC, Research Division - Research Analyst

That's really helpful. So I guess diving back in, you mentioned in your presentation as well your gain efforts. And we've had companies come up here for the last couple of days and you had different opinions on what [it takes to win] in the market. Can you talk about -- one, obviously, you guys are sold out, so clearly you're having success there. What are you going to do to maybe help the capacity issues there? And then as well why do you believe that technology is the one that's going to win in the long term and where those applications are going to be?

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

Well, I -- the Federal -- let's start with the RF. The gallium -- we believe that the gallium nitride on silicon carbide, power RF is chewing up the LD MOS share of the market by about 5% to 10% a year because of people penetration for high-performance applications as well as pure gain share -- share gain due to competitiveness in ASP reductions that are really creating some elasticity in the market. So that's happening, and it's good for us. And we'll keep supporting Sumitomo with our substrates and our fab, and we will grow with them and not only them in their market. For power, yes, the -- this -- it's growing. It's still lower, for us, at least. In terms of substrates, it's still lower than RF, but over time, we'll be the dominant share of the -- of our presence in the market. And the capacity -- as I said earlier, we have a number of initiatives at our -- from the R&D team perspective to improve the productivity of our alliance. We don't necessarily invest in capital. But having said that, the speed at the which the market is growing,



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we've been 50% every year. We keep adding capacity significantly every year, it's just not enough. And so the only way to increase that is just sometimes to add capital to spend money to buy new tools, which by the way, are our own tools.

Thomas James O'Malley - Barclays Bank PLC, Research Division - Research Analyst

Great. So GaN, obviously, one large opportunity for you guys. Moving over to the other side, stuff that we hear about all the time and [take] some opportunity. And in our discussions before, obviously, it's a large opportunity for handset guys but I think that you've done a really good job of kind of expressing how that market can proliferate outside of handsets as well. Can you talk about how big you think that opportunity is for you guys? And where are those other applications that people may not know about outside of handsets?

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

Yes. So first of all, the -- where we say 3D Sensing, we include LiDAR in it even if I know it's -- people call it differently. The only difference is whether to -- kind of the reach or the distance of which you are mapping the environment in a 3D way. I think the -- we are more and more engaged on customers, maybe they're not that big, but there's a lot of them. It's a very long tail of 3D Sensing opportunity from vacuum cleaning robots to drones to automatic sliding doors and you name them. I mean, it's really amazing how many applications there are out there that need a combination of -- image sensor with a source, which is not -- it's different than the ambient source, and therefore, can be seen by the image sensor better. And that's really what it is because people say, "What do you really need?" One of my board members always going to say, "Are you sure we're going to need lasers? People just do with cameras and AI. Isn't that good enough?" And it's the same reason why despite image sensor's so good, you still have a flash on your phone. Why they don't remove the flash? Well, because it helps. It's -- the cost is small. And eventually, the benefits are larger. So we see the deployment of lasers more and more across-the-board in smartphones, in -- as I said, a number of consumer appliances and consumer electronics products. And then automotive and all -- anything that moves will eventually have the ability to monitor the environment around it, not only the front or the back, sideways with the -- with laser for obstacles and detection and collision avoidance and so forth. So I know you wanted to ask some questions.

Thomas James O'Malley - Barclays Bank PLC, Research Division - Research Analyst

No, no, no. We're good. We're good. We -- if there's anyone in the crowd that wanted to get one in. Yes?

Joseph Eric Wolf - Barclays Bank PLC, Research Division - MD & Head of Equity Research

Joseph Wolf. As far as demand is seen in the data center markets that they're (inaudible)?

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

Yes. The way -- we don't sell transceivers at II-VI. So we only sell passives to the transceiver makers. We sell VCSELs -- high-speed VCSELs to the transceiver makers and then all the active optical cable makers. And then we sell some passive directly to data centers and some other kind of subsystems directly to data center. So we -- data mine, we see it as strong as it was last quarter. We don't see any -- at least for us, we don't see any decline or any changes. It's moving very fast to 400G. It's -- every time there is a technology shift, it kind of seems like that shift is happening faster than the previous shift. And it's very healthy right now. We have some -- there is no doubt there is some companies that are trying to catch up on cloud services and their capital planning is late, is old. They issue -- they come up with a capital plan -- I'm talking about 3 weeks later, they call us and say, "Oh, by the way, we were wrong. We're going to increase it by another 60%." And then 3 months later, they call us again, say, "Well, we need even more," so it's kind of a moving target, which is great. And it's all about trying to take share from the -- from Amazon. And everybody's trying to go up and take share from them. But -- so that's pretty exciting. And no, that's not only in U.S. because it's true also in China and Europe, I guess.



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Thomas James O'Malley - Barclays Bank PLC, Research Division - Research Analyst

I think there's time for one more. Yes?

Unidentified Analyst

You talked about (inaudible) silicon carbide and how do you see that evolving over time? And the competition is slightly [neck and neck].

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

Yes. Well, that's -- it's a fine balance between creating elasticity in the market and confining silicon carbide to niche. I mean, we don't want to do that. I mean, we don't want silicon carbide to become a niche technology. So we have to balance the 2. And I think it's so far so good because the -- again -- and the -- as I say, we are sold out, and we have -- the ASPs are not really an issue at all. So that will continue for some time, I don't know for how long. But we're also sensitive to what I just said which is it's great to be sold out in a sense that you have a little bit of leverage. On the other hand, we believe that some -- especially in the power electronics, if ASPs don't decline, we are not going to find a power -- a silicon carbide power electronics for your pool pump. I know -- I mean, it's all -- so in other words, how do you penetrate anywhere there is an active model whenever there is a power electronics demand that's only going to happen as soon as silicon carbide will reach targets comparable opposite to silicon MOSFETs, right? So that's what's going to happen.

Thomas James O'Malley - Barclays Bank PLC, Research Division - Research Analyst

It's great. And I think that is all we have time for. Thank you very much, Giovanni. Appreciate it, yes.

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

Thank you.

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