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IIVI - II-VI Inc at JPMorgan Tech Forum

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CORPORATE PARTICIPANTS

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

PRESENTATION

Unidentified Analyst

Good morning. Just in terms of introduction, I'm [Sukhneet Datibi], telecom, networking and IT market analyst at JPMorgan. With me for the next kind of fireside chat, we have II-VI, and we have Chuck as well as Gary with us to kind of go through a list of topics that we want to discuss around II-VI. Obviously, the Finisar acquisition is kind of top of mind, amongst those.

But Chuck, Gary, thanks for taking the time. What I'll ask you to probably do and start off with is, because all investors in the room might not be that familiar with the II-VI business, maybe if you can start off with a brief overview. And then we can kind of dive into the CS specific stuff as well as the different business segments after that?

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

Okay. First of all, thanks very much for inviting us this morning to present. We have lots of familiar faces in the crowd. I'd like to introduce Gary Kapusta, our Chief Operating Officer.

The format today is this fireside chat and a dialogue. II-VI is a materials company at the core. We have organized the company into 3 market-focused reportable segments, one called Laser Solutions, is focused on the industrial materials market, materials processing market, the short wavelength data communications market, the 3D sensing market, and other growing markets for semiconductor and CO2 lasers.

In the Photonics segment, which is -- was founded out of a large acquisition that we did in January 2010 in China, was a materials and 1-micron components company focused on making mostly communication components, passive components, but then began to branch out into other markets. We currently are focused on serving 7 of those markets, and I'll tell you what the 7 markets are in a minute.

Photop story, that was a Photonics company. And a little more than 5 years ago, we acquired the assets from Oclaro to make 980 pump lasers for optical amplifiers. We became a semiconductor laser company as well as an optics and materials company right at that time. And we decided to then focus our competencies on growing into the communications market with a set of semiconductor and optics and subsystems for the first time at the amplifier level.

Today, the Photonics segment is the largest of the 3 segments in the company. It is the most profitable segment, has been. Of late, is largely focused on the communications market, maybe 85% or so of its sales are derived from selling products into optical communications and data communications and have a product portfolio that depends on critical integration that results from the intercompany sales of 980 pump lasers from the Laser Solutions segment. And in the third segment, Performance Products, which I'm about to highlight for you, thermoelectric coolers.

So the company has basically, in an optical amplifier and on the road, a mind core itself that you hear about, we have the best the cost structure for anybody that makes amplifiers in the industry because we make pumps and passes and the coolers, and we have most of the content that's in the bond. So we're extremely competitive in that business in the last -- for the first quarter of our year, and then leading into the second quarter that we're -- have not announced yet on, it had a lot of momentum as well. The communications business have been quite strong.

So maybe just quickly moving to the third segment, the Performance Products segment. That segment contains the biggest business, and that segment is our military optics business. It runs roughly 10% or 12% of our sales. And then we have 3 materials-based businesses that are in that segment as well.

One is thermoelectric coolers that I just mentioned. The second one is engineered ceramics that we sell into the semiconductor capital equipment market mostly, both DUV and EUV lithography tools contain -- have a substantial amount of content of our materials and products. And then finally,



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one of the fastest growing businesses in the company, serving one of the fastest growing markets in the silicon carbide-based materials, substrate materials in the future, epitaxial wafer materials. So the combination of those 3 segments in our last fiscal year sized -- generated about \$1.3 billion in sales.

And one of the really exciting things for us is that 5 years ago, or 6 years ago, many blue-chip companies, many large-scale companies did not know II-VI. They knew some of our divisions, but they knew them by their division name and by their customized products. And in our fiscal year 2015, we had 6 customers that spent more than \$10 million with us in a year.

The last fiscal year, 2018, we had 26 customers that spent more than \$10 million with us. And then in a short span of time, the 6 went to 26 and the 26 spent almost half of -- accounted for almost half of our revenue.

And it was a substantial shift and represents the broad-based capabilities of the company and its ability to attract new and large customers that have interest in and need for other parts of the company that they didn't know that we have.

But it's really exciting, it's continuing on a number of new markets. So that's the profile for the 3 segments. What else do you want to do next?

QUESTIONS AND ANSWERS

Unidentified Analyst

Yes. So Chuck, as you kind of went through the business itself on a standalone basis, it's clear you have a broad set of capabilities. You addressed already a broad range of markets. Then kind of take us through the strategy or rationale here of combining with Finisar. What kind of capabilities were you looking at that weren't currently addressed internally? And what made you think that kind of the acquisition is kind of the way to go with that rather than going about it organically?

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

Okay. That was really a great question. Thank you. So we've done -- maybe just by way of a little bit of background, too. I joined II-VI in 2000. I was a board member for a couple of years. When I joined the company, it just finished the \$70 million sales year, had 1,000 people in it. And when I returned to the company in 2004 as an executive, the board of the company asked me to help lay out a strategy to diversify the company by both acquisition and organic investment. We've done about 20 acquisitions in the last 15 years or so. In that time period, we've been really selective about our targets. We have a disciplined approach to them. And in each and every case, we've had a path toward making more money with the businesses than what they were making for before they joined II-VI, probably because of the strategy and the rationale we have and the structure that we have focused on generating value at the materials level, the components level and the subsystem level. At the subsystem level, our main subsystem product is the optical amplifier, where it's a combination of optics, lasers, firmware, software, electronics. And there's a lot of added value there, for sure. But we grew the business up from the materials looking up towards the subsystem through the component. And our approach has been to maximize the full utilization of all of our assets. And in doing that, we have a willingness and an ability and the reputation to segment the market, such that we will sell material to people that we compete with at the components level. And we sell components to people that we compete with at the subsystem level. For us, it's just normal. Many people who start life from the top, at the subsystem level and build a vertically integrated business like Finisar did, they start from that level and it's just a strategy for them to hold onto the components and make their subsystem business as good as it can be. And so in just in a minute, I'll move quickly to Finisar. But for us, we have built this vertically integrated business, and we're not done yet. It's not a goal of II-VI to vertically integrate every material in a certain amount of time. It's our goal to be one of the best growth companies generating long-term shareholder value, and the only way we know how to do that is to invest in the right technologies and products at the right time, deliver them at the right price points and quality, have a road map that can refresh it and to maximize the returns on all those investments. So we're focused on delivering financial performance. We're not just a tech company or vertically integrated tech company. So when we looked out at the prospects that we've had, we've grown quite a bit, and we have aspirations to continue to grow.

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Our company will turn 50 years old in 2021. My view is as only the third CEO in -- of the company in 46 years, I'm in my third year on the job, been in the company for the last 15 years, almost 20 if you count the time at the board. And my view is that we're just getting started. And so 2021, when we turn 50, will be the end of the beginning for II-VI. And as we look out to the capabilities in the markets that we're serving and that Finisar is serving with virtually complementary technologies, complementary product portfolios, a similar culture, a similar vertical integration, a similar footprint globally, we believed that there's a lot of things that they've done really well. And a lot of those things that they've done really well would be real good fits with II-VI. So we worked for some time. You can read the S-4, the history of the transaction is all out there on the website, about how we're thinking about it. But when you put these 2 companies together, in combination will create one of the largest Photonics and compound semiconductor companies in the world, with among the greatest momentum profiles coming into the growth of the 5G markets, the continued growth of the DCI market as 4G and 5G wireless infrastructures get deployed not only in China, not only in India, not only in Africa, but also in Latin America. There's quite a bit more growth that we anticipate coming, and 5G is going to drive a substantial amount of it. It's already started for us. And when we looked at the transceiver capability, our view is that, that they're -- in a \$6 billion transceiver market, they're -- that's about to become a \$12 billion transceiver market according to industry experts in the next 5 years. In a \$12 billion transceiver market, there is an opportunity to make money. And underpinning the transceiver business of Finisar is a gallium arsenide VCSEL capability, which we have, but they have an indium phosphide-based laser capability, which, in my judgment, is world-class. And I have visited the indium phosphide fab in Fremont and indium phosphide fab in Jarfalla, Sweden, where they make tunable indium phosphide lasers for coherent and IT08-based transceivers. My view is it is the best in the world.

And there's only a few places in the world that have that capability that have been investing in it. And so if you want to be in that business, and you believe that more deployments, both wireless and wireline fiber optic-based businesses will continue. If you want to be in that business and deliver value, you need to integrate optics and lasers and electronics. And we could spend the next 10 or 15 years trying to figure it out, investing a whole load of money. Or we could combine with the world's leading company and put together not only their transmission business with our amplification and wavelength management business, but put together their world-class high-port count wavelength selective switch with our low-port count wavelength selector switch and provide customers with a full-line supply for their next-generation ROADM deployments which we believe 5G is going to drive large volumes of. So there's a second. Our ability to -- in the combined companies and our vision to begin thinking about the world as materials, components and subsystems, suggests that we believe that there'll be a market for -- there is a components market for some of the Finisar products that FIN is for today. And until today, have largely elected to keep in-house. We have a slightly different view about that. But in any case, what we're really excited about is that the foundation and the capabilities that they have, have been profoundly -- and have just been profoundly and greatly amazing to me. I haven't seen them. Two weeks ago, I was in Australia; Ipoh, Malaysia; Wuxi, China. The level of automation technology and the expertise in high yield, large area, highly functional indium phosphide-based components are things that we don't have. And the scale of the 2 companies, I believe, will drive us to achieve at least \$150 million of run rate synergies after a few years of working at it, \$85 million from the cost of sales, putting together one of the largest procurement organizations in the industry should drive some benefit. It will. The \$65 million in period expense synergies, we have a path to deliver that, and we are really excited even though we can't affect the operation or management of Finisar today, we can and we're working diligently to put an integration plan together so that when the acquisition closes, everybody knows exactly what to do, and we can begin to operate. It's really exciting.

Unidentified Analyst

Great. So let's talk about one of the overlapping businesses, which is 3D Sensing, just given the backdrop of the CS here. Where does II-VI stand on kind of for right now in 3D Sensing and consumer applications? And what kind of capability does Finisar bring? And moving away -- not away, but kind of within consumer applications, both II-VI and Finisar, I think, have relationships with Apple. So where do you stand in terms of smartphone opportunity itself as a combined company?

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

Okay. Let me say that as a preface, in the transceiver and the high-port count switch, WSS switch, we're not competitors. We are competitors in the 3D Sensing. So that's one thing. The second thing is that while we're operating in this period of regulatory approvals and governance approvals of our respective shareholders, we are responsible for and are competing with Finisar and any other players in the industry vigorously. We've established a meaningful position in the supply chain. And I want to correct something that you said. As a matter fact, in record that whereas Finisar



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had the opportunity and need for discussing some of their customers probably, we have never. We have not. And we have an obligation not to, so I won't. But I can say that I believe that we have established and are managing one of the very best capabilities for 3D Sensing as a vertically integrated company, not only in the United States but in the world. And when we made that investment, let me move quickly and then I'll come back to 3D Sensing at Finisar. When we made the investment, we acquired a nearly bankrupt publicly traded company called ANADIGICS, a small private company that makes epitaxial wafers. It's kind of a proxy or a look alike to IQE that you may know in this space. We went and stitched those 2 things together, those 2 platforms together, over a few month period and built -- went about the business of building a world-class capability for making optical electronic devices on 6-inch gallium arsenide wafers. The world said it couldn't be done. At least a few of us or at least 2 of us believe that it could be done, and went on that path to get started. During that time, we began looking to immediately to diversify so that we could provide additional devices into the fab. Because we weren't sure that a 3D Sensing market would exactly materialize on the timeframe that we thought it would, but it did. But we wanted to be able to do other things in here. So about 2 or 3 months ago, we announced a partnership with Sumitomo Electric, whereby we are providing GaN silicon carbide HEMT device qualification development and qualification services right now. I do expect in the calendar year '20 that we'll be qualified and begin shipping. GaN silicon carbide HEMTs to Sumitomo Electric, which according to market analysts, have the largest share of GaN silicon carbide devices for wireless-based station applications. And it's not only largest share, but the majority share in the world. And we are in the process of working intensely and intimately with Sumitomo Electric. And considering whether or not we actually have enough capacity in place to serve them in the next 2 to 3 years, and that's a topic, which is very much on my mind and Gary's mind and our team's mind. Because when the 5G wireless base station turns up, we think there's going to be a huge opportunity to serve them. And if they preserve their market share against any of the other fast attackers, I think we're going to be quite busy in Warren, New Jersey. And I was worried then when we started talking to them 2 years ago, that we might get out of capacity. So the first thing we did was look to acquire fab in the U.K. where we knew we would have the ability to add VCSEL technology. And that effort, we've kept at a slow but steady investment. And now here comes Finisar. Among the many things that are really exciting about Finisar is that we -- in the 3D Sensing market, we sell bare diode today, we don't sell a module. Our customers either are the module maker or is someone who utilizes a module maker to make their module for them. But we don't make modules, we don't have that expertise. But if you're the world's largest transceiver maker, you know something about making modules. And if you know how to miniaturize modules with electronics, with optics, with diffractive optical elements, if you know how to do that, you might be able to be real good at making modules. And what's really exciting about that for me is that we see the automotive market, long term, to be a real, real important market in II-VI. And as a combined II-VI and Finisar, I think that we'll be extremely well equipped based on their knowledge in lasers and knowledge in making modules, we should be able to put those 2 combinations together along with, by the way, a long wavelength capability for LiDAR applications based on indium phosphide, based on the competencies they have and our amplifier technology. So we've been talking in the last year we came to this show and started talking about LiDAR and indium phosphide-based modules for i-SAFE based components. And when you look at the automotive market -- when we look at the automotive market, and then we think about the capabilities that existed in Finisar and II-VI, we see it as a great emerging opportunity for us in our plan. So I will say until we close this transaction, we will continue to be vigorous competitors of each other in the 3D Sensing. And by the way, I was yesterday in the Sherman, Texas facility that has been much hailed and talked about and then the Allen, Texas facility where they make 3D Sensing lasers, it was my first time in the area. But I went yesterday, I talked to 500 employees there. I couldn't tell you how enthusiastic they are about the coming together with II-VI.

Unidentified Analyst

Are there any questions from the audience?

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

Yes, sir?

Unidentified Analyst

Yes. A very quick question about that, that I misunderstood. In partnership with Sumitomo, sounds like you're going to be ramping up on some of the specific carbide-based production. Is this specific carbide-based production basically integrated? Are you making your own ingots and wafers or are you using third party?



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

Yes, sir. The -- our relationship with Sumitomo is long, as it should be. It goes back 35 years ago, when I started working with them when I was at AT&T Bell Labs. We have been supplying them with -- until now with, semi-insulating silicon carbide substrates for them to do their own epi in their own fab. About 2 or 3 years ago, we started a large-scale program to expand our semi-silicon carbide semi-insulating capability to 150 millimeters. We have 150 millimeters substrate and we have a 150-millimeter wafer fab and we have a level of intimacy with them that goes back 35 years.

Unidentified Analyst

May I just ask an additional question? Presumably it's growing pretty rapidly. Are you also going after the auto sort of inverter market ultimately and how are you funding the growth? Because I imagine it's capital intensive.

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

Okay. Everything we do in the materials and components or device company that's vertically integrated is capital intensive. That's part of our strategy and part of our competitive advantage actually. But let me close up on the semi-insulating silicon carbide, we -- our customer, our channel into the market is through Sumitomo Electric for the commercial market. On the military market, for a military based radar in the future, will become a market opportunity for us to invest to make modules in. We haven't started that yet, but that's -- we like to think much longer than 3 to 5 years even. So that's -- the military market in the U.S., we think, is not as well served as it could be. And we think the market today is probably 1/5 the size of what it will be in the next 5 to 10 years. We see that as a growth market, and 10% to 12% of our sales are to military customers, so we see that. Let me move quickly to conducting silicon carbide, that's your question. The long-term growth driver for us is the silicon carbide materials company is, in fact, efficient switching and silicon carbide based electronics for inverters, for motor drives, for any AC/DC or DC/AC switching. And we -- when I joined the company in 2004, revenues for that product line were less than \$250,000. We -- I think we announced last quarter or 2 that we should be -- we're on a run rate in the company to have that business become close to 10% of our sales. At least on a run rate, close to. We're not there yet, but surely more than 5%. So between 5% and 10% of our sales. And what's driving it is the demand from the people who want to -- who are making inverters or making MOSFETs or making IGBTs. And they need substrates, and we have competition from 1 or 2 other people in the marketplace to provide substrates, but they also make components. And so there is a bigger opportunity for us at the moment, we think, probably because of that. So if your question is, will we ever make electronic components on silicon carbide? I think, the answer is it depends. But if you ask me, is it an aspiration? I'll tell you, yes.

Unidentified Analyst

Great. In the kind of last minute that we have of time remaining, can I just ask a high-level question, which is, with all the market opportunities you had outlined at the time of the Finisar acquisition, it's roughly \$22 billion, I think, that you put a number on it, the combined company still kind of will be 2.5, remains -- the market remains fragmented kind of market with a lot of suppliers. Should we see you as continue to being a consolidator in the marketplace?

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

Well, okay, that's a great question. I don't view us as a consolidator, I view us as a collaborator and a really a cooperater, for example. The Finisar acquisition, that everybody calls it that way, I see it as 2 companies coming together to make a substantial difference in the market. That market will remain fragmented. We'll be -- when we come together, we'll have about 70% of our sales into the communications market as opposed to 45% or so today. So we're going to be a lot richer in communications. But once we have got our integration plans behind us and we've delevered, I fully expect to have our acquisition strategy renewed. And that our tendency would be knowing what -- the only way we've operated in the past, our tendency would be to look to diversify into other markets and to take acquisitions on that would help us continue to grow. And we will continue to invest organically in the communication business, but our acquisition strategy may take us into a different direction. Okay? Is that helpful?



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Unidentified Analyst

Yes, definitely. Thank you for the time. Thank you for attending the conference.

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

Okay. Thank you very much.

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