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IIVI - II-VI Inc at Morgan Stanley Technology, Media & Telecom Conference

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CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

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

PRESENTATION

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

All right, well, everybody's coming up. I'm going to read the Morgan Stanley disclosure first, which will take 15 seconds and then -- so I am Meta Marshall, I lead up the optical coverage here at Morgan Stanley. We have Mary Jane, we have Chuck here and then we have Giovanni from II-VI, who're here. So please note any and all important disclosures including personal holdings disclosures and Morgan Stanley disclosures, if you're on the Morgan Stanley public website at morganstanley.com/researchdisclosures or at the registration desk. So we have the whole panel of management here. We're very excited. You guys obviously announced a very large acquisition kind of at the tail end of last year.

QUESTIONS AND ANSWERS

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

So maybe walk us through the Finisar rationale because I think kind of upfront, it' struck people as questioning what the rationale was. And so you've spoken a lot about, in kind of subsequent meetings about kind of changing this overall strategy at Finisar. So what is your guys' vision for Finisar and what it can kind of do for the combined II-VI?

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

So first of all, I think most of people think about Finisar as a [trend super] company. We think about them as a technology company. Because they have one of the best Indian Class V platforms in the world. It is a fully monolithic platform that has not only applications in data and telecom, but also in LiDAR. They have a very, very good product in the High Port Count WSS Switch. And both of those, the Indian Class V platform and the High Port Count WSS Switch, we would have otherwise developed ourselves. They also have a very advanced integrated circuit design team that will be very beneficial as we move forward in 5G. So when we think about that, we don't limit ourselves in our minds to the footprint that Finisar is playing in now, that's the first thing. The second thing is, we don't necessarily limit ourselves to their current go-to-market model. So in their lower end transceivers, as the world has evolved over time, Finisar, obviously probably invented the transceiver, made possible cloud computing. It's not unusual, they would be very attached to that product. But we have over time found that it is important to concentrate on the types of components most people can't make. And it's possible in their lower end transceivers that we may move to more of a component strategy over time. And if you think about it, the value in any transceiver is not proportional to the number of parts, every single part is not worth the same thing. The operative components probably are well more than half of the value. And so it may not be so important to make or buy and assemble every other last one. Now obviously, we're -- we do not want Finisar today, we cannot run them until the transaction closes. And there are customers for those transceivers today. There are also people who work on them. So it's important that when we get together, we look at the strategy together and carefully, but it has proved to us to be a very, very successful strategy and think that it will be here as well. There are obviously cost synergies that we'll be able to obtain. They have some very, very nice real estate in some good locations, for example, the Sherman fab has a 3.5 spent kilowatt hour electric environment, whereas historically for our company Pennsylvania was typically the lowest kilowatt hours, 4.5. We're a materials growth company, electricity is a big input. So there's a number of really advantageous aspects of this combination that might not be so obvious. Do you want to add anything, Giovanni?



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

Yes, I mean I think maybe you could expand for us, we've always thought as Finisar as a data comm transceiver company, that's maybe underperformed its potential in other sectors that it's tried to go into. So when you talk about LiDAR, when you talk about other areas, how do you make sure you kind of branch them out from the datacom shell we've kind of always thought of?

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

Okay. So first of all, thank you, everybody, for coming this afternoon. Thank you for hosting us. We start everything in II-VI, every investment decision with a strategy. And we took one a few years back that led us to this path. That strategy is going to lead to a structure that's going to be a little different than the way in which the 2 companies are structured today. And very quickly, before we get to the closing, the target operating model that we have to be able to deliver the value that we've talked about, \$85 million in cost synergies, \$65 million in period expense synergies. But importantly, servicing customers in growing markets, adopting the technology platforms that they've made large investments in that will obviate the need for us to make them in automation, assembly, testing and in an Indian Class, right, a world class, I should say, Indian Class V laser capability. So we started that all out. Once the organizational structure was known, we will deploy the target operating model to the entire leadership team of the company, align everybody with the changes that need to be made to deliver it and we'll focus on starting with the CEO on the culture and on communications and on the change that needs to happen in both companies in the face of the great opportunities that we are seeing, and to be able to make the best company in the industry. So I'm really excited about it, and it is going to require some change. And we have demonstrated our ability, I want to say that as well. We've done over 20 of these acquisitions. And we're not perfect at it, but practice sure counts. There are very few companies that have a track record that we have in the last 10 years of targeting, acquiring with a discipline, a financial discipline and then integrating and operating and sticking to that discipline to be able to deliver the kinds of value. In most cases, we've surprised people and in some cases, we completely shocked them because the businesses that we bought were largely overlooked by a number of buyers, including operators in the industry that turned their heads from them. This is a great opportunity. And we are going to make the changes that we need to make, stick to the knitting and I believe that we're going to have 25,000 very excited people before too long. And I'm looking forward to it. So please, let's go with the rest of your questions.

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

Yes. So people have been advocating for consolidation in optical componentry for a very long time. And 2018 was finally a year where we saw that between you guys and Finisar, Lumentum and Oclaro. Do you think more needs to take place? Or are we kind of at a digestion phase here where people want to see what happens with you guys before further acquisition activity takes place?

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

Well first of all, first thing I'd say is we don't see ourselves as the roller upper of this industry. We see ourselves as a company that's focused on the deployment of key materials in key end markets where we can have a competitive advantage. So we don't really position ourselves totally around, as I say, being a consolidator of one industry. Having said that, it certainly is quite a big deal to go from 4 of the larger companies down to 2. And given that some of the assets were also bought back in 2013 and '14, it wouldn't surprise me if we saw a period of [congestion]. But what you think?

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

So I want to say this, so our (inaudible).



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

Got it. So next I want to turn to industrial, kind of core II-VI. Your industrial lasers business, I have been super cautious the past couple of quarters and you guys have proved me wrong. There were not a lot of positive China data points, but yet your business continues to grow. So can you help us understand like why bad industrial China data points are not necessarily bad for you? And just how to think about how that business develops?

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

So the first thing to remember is, we only make components. So we aren't selling whole laser systems. And just at the surface level, where the components go and moving where they go, say vis-a-vis tariff constraints is a whole lot easier than making a decision on where you're going to put a whole laser system, right. So if -- in the case of laser systems being sold into China, the tariff on the machine isn't the issue, it's the tariff on the goods made off the machine so that the buyer of the laser system has to make a whole much bigger decision on where they're going to put their laser processing line for the goods that are coming in to deal with the tariffs, whereas all we have to do is redirect where the components are going. I would also say that we had also spent, since March, working with customers on where we would send things, where they would send things, where orders would be placed, in order to mitigate the tariffs. Because while most people thought if a tariff was on a good, people would just move to another supplier, that is not so easy to do. So that -- all of that was going on. But generally speaking, keep in mind, more than half of our industrial laser business is driven by the laser in use. So the aftermarket is a very strong part of it. The lasers are still being used. In the last 2 years, we saw the average laser build go from 5,000 to 7,000. We never really thought it was necessarily going to sustain at 7,000, it is lower than that now, but it's still above the 5,000, as we have transitioned certain things to laser power. That said, our growth rate certainly has slowed, and -- but all the same, I do think that we are making components for people who are probably challenging the supremacy of the more well known laser makers as those laser makers in China, whether it's Maxphotonics, Rayco, Han's, all make very, very good systems and start to see those systems more broadly deployed.

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

And maybe you can talk about how you've tended to see, in past kind of industrial cycles there, how you've detected -- you've always noted you've grown through kind of every downturn except for one. But just how to think about what your trajectory would be during any industrial kind of downturn?

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

Well, the funny thing is, that the first time industrial turned down was in the 6/30 quarter of '16, which was the first time optical picked up. And the funny thing here is that as optical starts to pick up, say, at the 9/30 or the 12/31 quarter, industrial was turning down. There was actually no real reason why they should be a perfect sine, cosine. But they have been for the last 2 times. But generally speaking, again, half the business is in the laser being used. And short of a strong economic turn down, so that's obviously what happened in 2009, someone actually -- we could actually see a lift in the installed base usage. While people say, rather than buying a new laser, I'll run on 2.5 shifts, right. So life moves on, cars need to be fixed, someone still needs a washing machine, and as the lasers are being used. But we watch those, that's why we think the economics, the just GDP growth, still is important, because that is usually indicative of goods being made off the installed base.

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

Got it. So I want to turn to 3D next. There's just so many good things, there's so many topics to cover. But maybe the 3D business has been slower to expand than expected. What are you seeing in the space? Like what have been some of the biggest hurdles to adoption that have maybe caused adoption not to take place as quickly as some?



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

Yes, sure. I mean, the -- it's a complex system. There is the optical part, there is the electronic part, there is the software part. And what we've witnessed is that most customers that kind of trying to enter that space or widen their functionality to their products, I think they underestimated the complexity of deploying a user-friendly robust solution to the market. And so we, from a component technology standpoint, I think we're ready, we've been ready, we've been supplying, we've been able to ramp to very decent volumes with our 6-inch vertically integrated platform. But it's clear to us that the combination -- a little bit of our IP barriers as well as maybe slower than necessarily investments, it's kind of put anybody else a little bit on the slow side of the deployment into the products. So this will happen eventually, we'll still be engaged, not just given up as far as we know, so they will continue.

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

And is there -- is it 2 years out, is it we have to get to other use cases like automotive, just when do we get past some of these hurdles?

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

So first of all, I just want to remind, we never invested on a 6-inch compound semiconductor platform only for 3D sensor, right. We saw the announcement of the gallium nitride and silicon carbide partnership with Sumitomo that is going into the same fab where we make the pixels on 6-inch. And we also -- we continue to make [free hand] gallium arsenide amplifiers. So we -- our strategy has always been to keep a very diverse set of platforms and end customers and end markets with our compound semiconductor platform, so I wanted to just say that. In terms of timing, we believe that probably -- let's say 2019 would be similar, maybe a little bit higher than 2018. But 2020 would probably be the year where there would be a substantial increase because there would be, again, there would be more time to test, deploy higher volume products out there. So that would take a little bit more time than we thought. We thought that 2019 was going to be actually the year, but we think 2020 is going to be better. Yes.

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

Okay. And I mean the combined II-VI Finisar will have a lot of production and capacity in house. Chuck, I'm very jealous, you've been to Sherman, Texas, so you know what it looks like. But what advantages does that combination offer? And what were the different strengths that both of you guys were bringing in house?

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

(inaudible) finish, okay, okay. Well, I think we should focus on the things that are in common. The starting out with a view that to be able to control cost and quality, and the technology roadmap to be able to offer increasing complexity of devices at high yields and possibly even integrated the license down the road to simplify the environment that the laser is in, we see the world in the same way. That's one thing that we have in common. The second thing I would say that we have that's different, they're experts in making modules, we're not. We make modules, but at relatively low volume, for amplifiers, for pumps for amplifiers. They're in the transceiver business, they've demonstrated for 30 years they have a mindset, a culture and a skill set to be able to design for miniaturization and integrate optics, lasers and electronics, we think for the 3D Sensing market, but more broadly. The sensing market including for automotive, that most customers in time are going to not want to buy individual [bear die], but rather buy integrated miniaturized assemblies in a box. Those look like the transceiver. And we really like that we'll be able to work together to define a roadmap to be able to offer new markets because we want to take the capability and focus on the automotive market, on the IoT market, on the Industry 4.0 market for making precision distance measurement for robots and automation. There's a whole host of things that we can do. The mindset in the management team is very common, has a lot of commonalities to it. And the one thing that they have that's really different from what we started with, we started with a facility that's relatively older. And we've done one heck of a job with it. They've got a brand-new facility, brand-new equipment and that combination is really -- should -- I'm expecting it's going to make a big difference in terms of their ability to hit the ground running. And the scale that's there, it'll allow us a number of alternatives with regard to maximizing the profit margin in the company over time by allocating the right resources in the right place at the right time.



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

Got it. So another growth area, silicon carbide, it's been tremendous category for you guys. You have clear advantages as that market hits an inflection point. Can you just talk about, a little bit about power versus wireless? And kind of how you see those markets developing and what keeps you kind of at the leading edge of that opportunity?

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

Right. So in 2016, 100% of our revenue was in RF or for wireless. And then in 2017, power started to just ferociously take off as certain world factors like Germany deciding it might outlaw combustion engines in 2035; China thinking it might settle its western provinces largely on electric vehicles to avoid the air quality problems it has in Beijing, and power really began to take off. And now today, in our revenue today, it's about 55% or 60% power and the opposite in RF. So we believe that power will, in fact, in the long run be far and away the larger market. And we are seeing many, many customers developing power devices on our silicon carbide, not only for electric vehicle test is the primary market where we're seeing this start to come up, but also the beginnings of potentially some industrial applications. There is not a market study today, but our view is, probably if we predicted where the next new silicon carbide market setting would be, it would be silicon carbide for large electric motors. Having said that, our view on the wireless side is that 5G wireless base stations will require GaN on silicon carbide. And some of that is because the amount of power that's going to come across that base station will deteriorate a GaN on silicon device too quickly. And why have 5G if it's going to go down every 20 minutes. So certainly people who make GaN on silicon devices, I'm sure will have markets themselves, but we think GaN on silicon carbide is going to be very important in 5G. And 5G itself is going to be very important to just deal with the amount of bandwidth that's required, not only for the way people are computing today as consumer computing and communications all converge. But even autonomous driving vehicles are like little moving data centers. You're not going to have very many of those if we can't communicate in 5G. That is really an exciting area. And we announced in December an alliance with Sumitomo Electric or SETI as we call them inside to make GaN on silicon carbide devices for them on our 6-inch -- in our 6-inch fab in Warren, New Jersey. We're excited about that because Sumitomo Electric has 70% market share in this area. And I think that, that is a very, very good indicator that we're going to see GaN on silicon carbide devices there. Most of the 5G -- the 4G wireless base stations in China are made on silicon carbide and it's ours. So it's an exciting market. Its material will be very, very ubiquitous. And when you looked 20 years ago to find the next 50-year material, we think this could be it. But its ability to convert DC to AC power, its semi-insulating properties is very, very valuable in power conversion and in heat dissipation that makes it a tremendously sought after material, and we think it will be for a long period of time. So you want to add anything?

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

No.

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

I mean, but as far as competitive advantage, [so] kind of keeping them -- keeping your competitive advantage?

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

Right. Well, I mean we have been in the forefront of this for a while, because we only sell the substrate, 100% of our mindset goes into what does the end customer need for their device. Because we don't make those devices inside, we also have no tensions inside about who gets the substrates. All of our substrates are sold into the merchant market. I mean certainly the only other major merchant supplier today is the Wolfspeed division of Cree, and they're certainly very good. [Argue with], obviously, we could see ROHM and Dow who only make it for themselves today, it's not impossible they could come into the merchant market. And we do expect based on some 1-inch substrates we see coming out of China, but probably in the fullness of time we will have an Asian competitor in silicon carbide. But this is a seriously big market. We think the substrate market is \$1 billion by 2023. And I think our having been on the forefront of investing in this platform all along, we never tried to sell it, we have always thought this material would be important. We believe that we will stay in the forefront of the technical development in this area.



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

Yes, to add, if only to summarize, our differentiated advantage, it will come in the form of diameter expansion ahead of the market need, scale ahead of the market need, and the best quality substrates from the, this location [and] I mean a defect [bends on your] surface finish. And ultimately to provide a foundation for our customers to generate the highest yielding, highest reliability license for the power electronics market. If we do that, and that's our goal, if we do that and continue to offer the best that money can buy, no matter what people do with other substrates, I believe that they will find a road back to us. In other words, they will keep part of their supply chain at least tied to us, even if they own their own substrates.

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

Got it. There's a lot of enthusiasm about China ROADMs today. Clearly, it's been a strong category for you guys in the last couple of quarters, you've mentioned it a lot. So just how do you see that opportunity developing? Help us think about that over the next couple of years.

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

Well, I mean so first of all, we'll be the last people to try and predict an optical cycle, because at least between Chuck and Giovanni, they've probably lived through all of them, and they can be -- they can have lots of their own. But generally speaking, we have been seeing the bookings and the demand from customers and their ongoing discussions with us on longer-term agreements going on since the 3/31 quarter of 2018. It is really seriously picking up. I say, we continue to see in the more short-term here, demand still being good in terms of bookings here in the 3/31 quarter. So I don't know that what we've seen in the growth is all just buying ahead of tariffs. But if you think about it, China's desire to move the total economy to a knowledge economy, that's not very easy to do without bandwidth in a very, very big physical footprint country. And they are very committed to their 5G rollout. If you remember back, maybe in, was it '17 or -- '17, at OFC, they had just announced a \$157 billion investment in their optical structure right about the time the market was turning down for inventory correction. I don't know that that \$157 billion is going away. I mean that investment is important to them, and I think that we will see that they a market for a good long time here. Having said that, China's #1, and the optical market can be volatile. And going into a pause for a period of time, I think people need to not overreact to that. It is not an ongoing sequential up, growth over growth over growth, quarter by quarter by quarter. Hanging out at the peak for a while is not the worst place to hang out, if the market is kind of resettling as the industry, particularly in China moves farther and farther west in the country, which is at least right now, somewhat less populated, right. So they need the people to do the work, et cetera, et cetera. But I do think that there's a drive here that will be important to that country's ongoing economic development.

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

Got it. Any questions from the audience?

Unidentified Analyst

Few questions there. So firstly you didn't sort of touch on the elephant in the room, which is the prepayment that Apple made to Finisar what they call confusion, but it seems like prepayment...

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

There was no prepayment. There was no prepayment.



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

It's actually very clear. Finisar having to put a press release out at 2:00 in the afternoon tells you a lot. So it's \$300 million of future business. There was no prepayment, there was no cash. But go ahead.

Unidentified Analyst

So there's no actual cash that was...

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

There was no cash that transacted.

Unidentified Analyst

Oh, is that right? Okay. Well, I guess it was not very clear. It would seem like they had ...

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

Well, that's why they put a press release out at 2:00 in the afternoon on the same day.

Unidentified Analyst

All right. Yes, okay. Good. The second question is with respect to optical in general, which I've been investing in for 30 years or something. One of the elephants in the room now is a president who seems to confuse things by punishing individual Chinese companies, which seem to be large consumers of components from your company and others.

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

Well, the whole industry.

Unidentified Analyst

Yes, the whole industry. So how do you even manage around that? Because they want to keep buying, it's that just that the president keeps punishing them and like what happened to Acacia and ZTE stopped the sale, so how do you manage around that?

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

Well, I think -- do you want to answer that?

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

Well, first of all, I mean it's very different comparing Acacia to Finisar or Lumentum is not fair because as you know, anybody can make the transponders that Acacia is making. I don't -- I'm not sure how many Indian phosphide platforms or gallium arsenide platforms there are in China. So...



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Unidentified Analyst

It doesn't matter, that still president doesn't allow you to sell to ZTE, then that's a problem, right?

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

Right. For the first thing is, we haven't gotten that far yet. So right now, people are just continuing to work.

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

So I -- well, I agree, that's a challenge, but okay, so we don't sell, our competitors will also not sell.

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

That's [an idea of].

Unidentified Analyst

You're feeling some of that investment. I mean doesn't matter whether you sell it or (inaudible)...

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

(inaudible).

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

All right. So we are out of time. But I think I do want to let Chuck -- so I think you've given a good explanation in the past about you guys having operations in China and a contingency plan, like were things ever to be of -- would you look at kind of separating Chinese facilities? Or just kind of what you think about, if restrictions were ever put in place, longer term, not shorter term, what you would think about kind of separating China and U.S. operations?

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

Okay, let me start out and do it in the following 3 orders. And thanks, Meta's referring to a question I was asked in London in December, and an answer I gave. Number one, we obey and follow all governmental orders. If there were 1 issue, we would follow it, like we have all the others in the past. Number two, our business at the moment, it does not seem to be affected plus or minus by the communications that are happening between the 2 governments. We take note of it. Number three, we have a large presence, deep, broad and we have dedicated ourselves to being a global employer and a caretaker to all 11,000 employees, every domain that they work in. And I think that we're -- we may be one of the very best companies of our style, not only in the Fujian province, where most of our people currently work, but perhaps in all of China. And I think that we're recognized for that. Our customers seem to value the relationships that we have with them, and so do our employees and our company does mutually. If in the event that there was sharp -- or a sharp change, if there's a sudden change, or even if it's a slow change, we would have to and I'm responsible for assuring safety of our employees and the long-term shareholder value of our investors. And we would be thoughtful about the alternatives and we would think deeply about them. But knowing our past, it wouldn't be unthinkable that we would consider an alternative model to be able to a, preserve the safety of our people, the continuity of our customers and the value to our shareholders.



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

Got it. Well, we have definitely -- it's past time, but I want to thank Chuck, Mary Jane and Giovanni for being here today.

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

Thank you.

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

Thank you for coming.

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