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IIVI - Q3 2019 II-VI Inc Earnings Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the II-VI Incorporated Fiscal Year 2019 Third Quarter Earnings Call. (Operator Instructions) As a reminder, this conference call is being recorded.

And now I would like to turn the conference over to Mary Jane Raymond, Chief Financial Officer. Ma'am, you may begin.

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

Thank you, Glen, and good morning. I'm Mary Jane Raymond, the Chief Financial Officer here at II-VI Incorporated. Welcome to our Third Quarter Earnings Call for Fiscal Year 2019.

With me on the call today is Dr. Chuck Mattera, our President and Chief Executive Officer; Dr. Giovanni Barbarossa, our Chief Technology Officer and the President of the Laser Solutions segment; and Gary Kapusta, our Chief Operating Officer.

This call is being recorded on Wednesday, May 1, 2019. 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 the call over to Dr. Chuck Mattera. Chuck?

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

Thank you, Mary Jane. Good morning, everyone, and thanks for joining us today. It was an equally exciting and productive quarter for II-VI.

Before I review our results, I would like to give an update on the Finisar acquisition. First, I would like to thank the boards of both companies, Finisar's CEO Michael Hurlston, the Finisar leadership team and particularly the II-VI employees around the world who worked tirelessly to deliver another solid quarter's performance.

The transaction was approved by 97% of the shares voting at our special meeting and 99% of the Finisar shares voting at its special meeting, both on March 26.

It has also been cleared by 4 of the 5 required countries, all but China, where Phase II of the Chinese process under the State Administration for Market Regulation is well underway.

While we cannot predict a closing time line, we are engaged with experienced U.S. and in-country advisers on the filing process in China, and we remain optimistic that we will be successful in a reasonable timeframe, which we still believe will be midyear.

The feedback from our customers about the combination continues to be extremely positive as they anticipate the benefit of the increased size, the technical depth and breadth of our people and our complementary portfolios, our ability to scale and our relentless drive to serve them.

Although we cannot engage with customers about any planned actions of the combined companies, we are listening to their ideas and inputs for new business opportunities around optical communications, the growth and evolution of Hyperscale data centers and the increasing adoption of 3D Sensing and LiDAR.

We believe that our combined market leadership in the rapidly accelerating global 5G infrastructure deployments, which have already begun and will continue for several years make this an opportune time to be combining.

To help plan for a smooth integration and position us to derive the benefits of increased scale, we have created a transformational integration management office staffed by experts from both companies with world-class consulting advice to help run the process.

I am pleased with their progress as we detail the plans required to ensure confidence in the delivery of the $150 million of cost synergies over a 3-year period.

In fact, we are also using this process to design transformative approaches to leverage the scale and best practices of both companies.

Now turning to the quarter, our teams collaborated to overcome some near-term unfavorable conditions in the market with our #1 3D Sensing VCSEL customer and yet they still delivered another solid quarter within our guidance.

Bookings of $359 million grew 8% compared to last year following significant bookings last quarter.

Led by growth in our Photonics segment, the revenue of $343 million grew 16% and EPS on a non-GAAP basis grew 35%.

Our strong position in the optical communications market showed outstanding growth for the company at 44% compared to Q3 of FY '18. Most of the growth came from extremely strong laser and optics component and subsystem demand for ROADM and undersea networks.

ROADM products grew over 80% year-over-year. In fact, during the quarter, all areas of communications grew compared to last year with the exception of Datacom, which is now only about 8% of our communications revenue.

Sequentially, revenues were steady as customers and suppliers took more time than in the past for their Chinese New Year holiday.

Based on market momentum, a significant uptake in bookings in March, the timing of our capacity additions and our successful penetration into new accounts, we expect demand in the global optical networking market including in 5G optical networks to continue to drive strong growth in the second half of the calendar year.

Our revenue into the semiconductor capital equipment market grew 29% as the EUV market remains strong for II-VI. Demand for our market-leading silicon carbide substrates was also very strong and now accounts for 6% of our revenue.

Of particular note is the 70% growth over last year for our substrates led by those OEMs making silicon carbide-based power electronic devices including for electric vehicle applications.

The industrial end market overall for II-VI grew sequentially but was slightly down year-over-year.

However, early indications from customers are that the market is strengthening, particularly in China.

Turning now to our 3D Sensing business. Our year-to-date revenue has increased 52% and accounts for 4% of our consolidated year-to-date revenue. In Q3, however, our forecasted revenues did not materialize as expected as the 3D Sensing market was not only seasonally soft but overall has been developing more slowly than was expected.

Therefore, we reduced our inventory build plan during the quarter and accelerated operational cost controls to record only a $0.06 negative impact of these conditions in Q3.

This slower market demand is expected to negatively affect Q4 EPS by at least $0.06 and even higher in our conservative scenario before seasonally strong demand resumes in the second half of calendar 2019, which we are in the process of operationally preparing for and looking forward to.

3D Sensing demand had the largest effect on the Laser Solutions operating margins in the quarter. And having said that, our work on new designs is progressing extremely well and our recent design win for a major Android platform should be realized as revenue in calendar year 2020.

I look forward to a strong close to FY '19, completing out another very good year. And with that, I'll turn it over to Gary to discuss some of our operational initiatives and achievements. Gary?

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

Thank you, Chuck, and good morning. As a function of the quarter's results, communications accounted for 47% of revenue; industrial, including automotive, was 25%; military was 10%; semiconductor capital equipment, including EUV, was 8%; and consumer electronics, including 3D Sensing was 2%.

Our silicon carbide substrate business across all end markets accounted for 6% of revenue.

Geographically, Q3 revenues were distributed 42% in North America, 21% in China, 21% in Europe, 8% in Japan and 8% in the rest of the world.

Our largest capital investments were in EUV materials, silicon carbide substrates and optical components for communications applications, especially in support of 5G and submarine deployments.

These factories are operating at full utilization. We are continuing to install additional capacity, consistent with our record backlog and customers' forecasted demands, supported by long-term agreements matching our profitable growth objectives.

We now expect our CapEx to be about $150 million for the year. We did take the opportunity in Q3 to flex labor down in certain parts of the business. For example, we did this to allow the majority of our workforce in China to take some well-deserved time off to enjoy their Chinese New Year holiday for the first time in recent years.

This was aligned with the work schedules of our customers. We also temporarily reduced work schedules based on a lower 3D Sensing inventory build plan. We are now several quarters into our cost control campaign and we are beginning to see good results, though this is only the beginning of what will be a sustained journey for II-VI.

We continue to tighten our cost and expense controls across the company to offset onetime expenses associated with the anticipated Finisar acquisition.

Our goals are to continue to provide our customers with the best-in-class quality product at the lowest possible cost of ownership by continuing to leverage a vertically integrated supply chain, a maniacal focus on controlling expenses, operational excellence, fully utilizing our installed capacity and by accelerating our material and labor productivity efforts. With that, I'll turn it over to Giovanni.

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

Thank you, Gary, good morning. Since the last earnings call, we presented the three important trade shows. Photonics West, OFC and Laser Photonics China where we displayed our latest technologies and product platforms. They were enthusiastically received by customers across many end markets.

In the industrial materials processing market, we announced a modular high-power laser processing head, which offers the ultimate flexibility in focus control of the laser beam with a broader range of optical expansion models. This head enables a wide range of application-specific laser welding tasks, including welding of batteries for electric vehicles, for which we can already report our first design wins in which we expect to drive renewed growth.

We also announced the third generation of our board-leading laser cutting head, extending its power rating up to 15 kilowatts to meet the growing demand for faster and faster cutting speeds.

The opening of our service center for high-power laser beam delivery systems in Xuzhou, China complements our North American and European centers to support our customers for new and existing products.

In their backed biomedical and scientific end markets, now 4% of our total revenue, we introduced a family of fiber-coupled visible lasers for flow cell cytometers that enable more precise cell counts.

In communications, we demonstrated our new 56 gigabits per second pump for VCSEL arrays for 200 and 400 gigabit internet applications. We also announced a low port count Wavelength Selective Switch, or WSS aims at meeting the performance and cost requirements of ROADM nodes for 5G networks. And I'm pleased to report our first WSS design win for undersea optical networks. This expands our share of the undersea optical network market, which includes pump lasers, mux/demux filters and detectors.

Our collaboration with Sumitomo Electric Device Innovations is progressing as planned for an on-time production ramp of gallium nitride, silicon carbide, power-led devices in the second half of 2020. In addition, as an industry leader in synthetic diamond, we shipped our first diamond-coated substrate, enabling high-performance gallium nitrate RF-powered devices in demanding radar and satellite applications.

For 3D Sensing, we've made a great progress on several new and complex designs that we expect to start shipping in the second half of calendar 2019.

Our adoption of 3D Sensing technology in Android phones is materializing. And we're very excited to report a design win with the smartphone market leader while we continue to work on several others in parallel.

Our customer engagements for LiDAR applications continues to grow, thanks to our broad offering of optical components and laser sources, ranging from compound semiconductor lasers to optical fiber-based platforms to Ceramic YAG [diode pan] solutions.

In the military market, our acquisition of Redstone Aerospace allows us to expand our beam-director capabilities with high-performance solutions for high-energy laser applications and accelerate the deployment of next-generation defense laser systems.

With that, let me turn it over to Mary Jane.

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

Hello, good morning. The company's overall gross margin for Q3 was 37.2%, reflecting the factors my colleagues have discussed as well as the mix shift toward optical communication. The operating margin was 9.1% or 10.3% adjusted for acquisition-related expenses. The EBITDA margin was 16.3% on a GAAP basis and 17.5% excluding transaction-related costs.

Regarding the segment operating margins, the Photonics adjusted operating margin of 12.4% is above last year's Q3 margin of 11.5%.

For Performance Products, the quarter was lower at 11% adjusted operating margin. But year-to-date, the adjusted operating margin is 12.7% compared to 12.5% for the same 9 months of FY '18.

The Laser Solutions Q3 operating margin of 6.2% was affected by the seasonally lower 3D Sensing business. But overall, it's ahead year-to-date at 9.9% compared to 8% for the first nine months of 2018.

The effective tariffs remains relatively immaterial in the quarter. The cost reduction actions both Chuck and Gary discussed are important for profitability and cash flow. While some very large markets are beginning to inflect upwards, namely 5G, they are not yet at a point of full demand, keeping competitive dynamics in the market still very intense.

As a result, it's the exact right time to innovate on our production methods and supply chain practices to improve our cost structure as our markets grow.

The Q3 record backlog of $531 million grew 4% sequentially and continues to show good market strength. This backlog consists of $228 million in Photonics, $208 million in Performance Products and $95 million in Laser Solutions.

The backlog contained orders that we'll ship over the next 12 months.

Capital expenditures this quarter were $33.8 million. The Q3 FY '19 tax rate was 9%, and we expected a tax rate of between 15% and 18% for the full year. The Q3 tax rate was favorably impacted by the attainment of high tax status at infrared optics plant in Xuzhou, China as well as the tax attributes of Redstone.

The reported EPS in the quarter was $0.38 a share and $0.52 a share on an adjusted basis. The adjustments include $7.9 million in share-based compensation, $4.2 million in amortization and $4.1 million in acquisition-related onetime costs including those for the planned acquisition of Finisar.

Our cash is $221 million, reflecting our $30 million acquisition of Redstone and our net debt position is $287 million. We did not repurchase any shares this quarter and still have $31 million remaining on our authorization.

We are ahead of last fiscal year's record cash flow from operations at $114 million for the 9 months year-to-date.

With respect to the financing aspects of the Finisar acquisition, we completed the work to obtain our corporate debt ratings.

We obtained a B1 rating from Moody's, a BB minus rating from S&P and a BB rating from Fitch.

The term loan A and revolver are both fully placed at LIBOR plus 200 and we have launched the term loan B marketing.

Turning to the outlook, the outlook for the fourth fiscal quarter ending June 30, 2019, is revenues of $343 million to $353 million and diluted earnings per share of $0.33 to $0.39, including $0.11 to $0.13 of integration costs.

On an adjusted basis, the earnings per diluted share is estimated at $0.63 to $0.71, which includes $0.12 for share-based compensation, $0.07 for amortization expense and $0.11 to $0.13 for planned integration activities. This is all at prevailing exchange rates.

The weighted average share cap is 65.7 million shares. This quarter, the convert remains slightly antidilutive, so we need not add back the 7.2 million shares.

Now as we turn to the Q&A for this call, remember that our actions may vary -- our actual results may vary based on product mix, customer orders, competition and general economic conditions.

I'll also remind you that our answers to your questions may contain certain forward-looking statements. We will answer them on the basis of our best knowledge today, and that actual results may differ materially.

In addition, during the Q&A, we will abide by our obligations to protect our customer confidentiality.

Lance, you may open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of James Ricchiuti from Needham & Company.

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

Chuck, I was wondering if you could maybe expand on the comments you made about seeing some signs of recovery, presumably, you were referencing the industrial part of the business in China.

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

Yes. Sure, Jim. Good Morning, thanks for your questions. The -- I would reference it right through today. January and February were typical, February was a little slower than usual. March was almost explosive for us. And it seems that, including just in the last few weeks or so, we seemed to have a lot of chatter and requested on the industrial market -- from the industrial market in China in particular. The -- that's the gist of it.

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

Okay. That's helpful. Mary Jane, I am wondering if you could talk -- if it's possible, break out some of the impact on gross margins with respect to the 3D Sensing business. Was that much of a headwind on gross margins? I know mix certainly impacted the gross margin this quarter in terms of the optical shift. But was the underutilization in the 3D Sensing business an impact as well?

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

Well, I would say, that was most of it.

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

Okay. Terrific. And one final question for me. Just I was wondering if you might elaborate or give us a little bit of color on the small acquisition on the military side, Redstone.

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

Okay. Let me take that, Jim. Thanks a lot for that. As we mentioned either one or two calls ago, we've also acquired another small company. We are intending to build out and revolutionize high-energy laser technology, enabling a new class of systems for our customers. These two investments underpin irreversible market trends and the intrinsic and asymmetric advantages of deployment of high-energy lasers for multiple new military applications. Although they are small, they fit real nicely and is a great example of II-VI acquisition strategy. I believe and I'm expecting that just those two small acquisitions alone in combination with the business that we have could contribute greater than $200 million of revenue over the next 5 years. Just to give you a sense.

Operator

Your next question comes from the line of Tim Savageaux from Northland Capital Markets.

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

Couple of questions for me. First, if we can focus on the communication side -- well, maybe, I'll combine these 2. You saw very strong bookings, I think, orders up nearly 50% year-over-year. Wonder if you could kind of dig into the drivers there from a geographic standpoint to what degree you're seeing China as a major contributor here and to the extent we're looking at China mobile backbone upgrades later on in the year. To what extent you think that demand is sustainable in the communication side in China? And then just looking at the overall guidance, to what extent is that reflected in your go-forward guidance. You talked about industrial really bouncing back, you had a very strong order book in Photonics, the guidance is up sequentially, but you're pretty modestly so. I wonder if you could talk about kind of what's impacting that relative to both very strong Photonics bookings and your anecdotal commentary on the industrial side.

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

Okay. There's a lot here. I think we'll have to team. Let me make some comments and Mary Jane can listen in and absorb and then maybe reflect on the guidance. But Tim, let's take your first question about the market itself as it relates to communications. Here's what we're seeing. In Europe, I would say, they have been slightly softer, but demand, especially around 5G, is increasing. In North America, it's stable, strong and coherent, offset by a slower demand in cable TV, particularly as the large acquisition that we see in front of us that we are part of the supply chain of and source itself out. Here's the strong demand, very strong overall is coming throughout the supply chain that we serve both in China and in India. So maybe that's a good starting point. We see the beginning of this 5G trend happening. We're expanding our capacity. We've sold out our pumps, our passives, our amplifiers, our channel monitors, our wavelength selector switches. We're in a state of extreme demand on us.

And I'm expecting, based on our checks with customers and our discussions with customers, I'm expecting it to continue into the second half of the calendar year.

And maybe, I'll stop there, let Mary Jane take the guidance and we'll come back to industrial because you got quite a few -- you're trying to get a discount asking three questions all at the same time.

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

So Tim, I'd say with respect to the growth in the quarter, we had a decent amount of it from China. But while I would say that we perhaps had -- we had good contributions in the growth from China and from Japan. While not so much from the U.S., the U.S. market remains very, very strong. The U.S. market so far had been the strongest contributor to the communications growth, actually.

So that's the first thing. The second thing is with respect to kind of how we're thinking about the guidance. So first of all, we are beginning to see a pickup with our guys in the -- who are responsible for the communications business have worked very, very hard over the last 3 years to increase in link at longer-term agreements. And therefore, unlike what we may have seen in optical communications 5 years ago where bookings in a quarter term into revenue the next. This is not all revenues and slight adjusted shift next quarter. So we looking at a very, very nice growth trajectory, we think here, but not so much -- and it will be in next quarter as well, but it isn't all in the next quarter, it's probably the main thing to say.

I would say that while we're also hearing good indicators from customers on industrial picking up, I'm not sure it's a straight inflection up in Q4. So we've been a little bit cautious about how much we've counted on that, and then for 3D Sensing, it is traditionally one of the lower quarters notwithstanding that we are significantly gearing up in the back half of the year. How did we do on that?

Operator

Your next question comes from the line of Sidney Ho from Deutsche Bank.

Shek Ming Ho - *Deutsche Bank AG, Research Division - Director & Senior Analyst*

I want to ask about on the silicon carbide side, can you give us a sense how much of your silicon carbide revenue has come from long-term contracts that you have a pretty good visibility on. Are these long-term contracts they have minimum volume, take-or-pay? Do they have scheduled step-down or volume pricing? And do you expect the portion of the long-term -- revenue from long-term contract to increase over time? That's my first question.

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

Okay. So first of all.

Shek Ming Ho - *Deutsche Bank AG, Research Division - Director & Senior Analyst*

Lengthy part.

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

Okay. Yes. The silicon carbide business is probably one of the most booked product lines we have. So I'd say nearly all of the silicon carbide business is on long-term contracts. So that's the first thing. The second thing is with respect to your question about, I think, overall economics. Our company has been very, very focused on contributing to the long-term growth of this market. And to that end, this is the reasons that we have also worked on our production innovations to both increased yield and output, but also look at how the cost of production progresses over time. But in any event, I think I got most of questions there. Tell me if I didn't.

Shek Ming Ho - *Deutsche Bank AG, Research Division - Director & Senior Analyst*

No, you got all of them. My second multipart question is that in terms of capital spending, you guys talked about $150 million today. In the past, you talked about -- in the fiscal '18, you talked about how much you spend on each division of each segment, I think it was $27 million of silicon carbide. Can you give us some sort of similar breakdown for this year? And on -- specifically on silicon carbide, can you give us a framework how you think about the growth in CapEx in silicon carbide relative to your revenue growth. Are you looking at CapEx to forward-looking 12-month sales? So any metrics that you look at to just that kind of capital spent, that we'll be great.

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

Okay. So first of all, we give the breakdown of how the capital was spent at the end of the year. We actually don't do it by quarter. But I can tell you of the capital that we've spent so far in this year, a decent portion of it has been for silicon carbide. As I just mentioned to you, silicon carbide is probably one of the most booked businesses we have. With respect to the capital investments in silicon carbide, I think it's important to think about investments period, including those that are in what effectively is OpEx and engineering. Because the single greatest advancement in the capacity of any grown product, silicon carbide, diamond, whichever, is actually the ongoing yield improvement, which is why Chuck says, "We have a yield improvement plan at every single factory that we own."

So we would be looking to both innovate on how the material is being grown, tested, et cetera as well as CapEx for additional machines. So as we look at the CapEx for silicon carbide, first of all, I think as you know, the vast majority of the industry, but certainly we build our own machines, that we don't just build them one at a time. We do put a tranche in at the time, but we also time that to the demand of the customers. So I would expect in the silicon carbide case that we're probably in a period for some time now of capacity pretty much continuously going in by tranches. Go ahead, Chuck.

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

I would like to -- Sid, thanks for your question and thanks, Mary Jane. I would like to add, we believe, that market analysts have and are underestimating the requirements for silicon carbide substrates. We have a plan to double our capacity over the next 18 to 24 months. We will expand our output on the basis of improved productivity and yields, as Mary Jane said. And we are in touch with customers and even though our capacity plans are doubling in 18 to 24 months, to sustain our really bullish view about this market, we may accelerate that. We may slow it down on the basis of market conditions, but that should give you some sense for the rate of capacity additions, based on our belief in both the market and our strong position in.

Operator

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

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

A couple of questions. Just on the ROADM business, kind of when you talk about the growth you're seeing in that, is that purely CoAdna? Is that kind of pump lasers and other things that you would kind of consider overall ROADM demand? And then maybe second, on the Datacom business, you mentioned that it didn't grow. Just any commentary there on what you're seeing, maybe intra-data center versus inter-data center?

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

Okay. So let me do the data center one second. Let me just come right to the point. We have been and are continuing to experience strong demand for pump lasers, optical channel monitors, passive components, EDFA modules, ROADM line cards, WSS optics and WSS. What I mean is, across the board, our full line portfolio is in strong demand and that's what's driven more than 80% growth that I referred to earlier.

With regard to the intra-data center and the data center market, the decline in the Datacom market that I reported, we're expecting that market to begin to come back in the second half of 2009 (sic) [2019], but not at all inconsistent with reports from the marketplace about a slowdown in the Datacom business, some channel inventory. We've experienced that, but our discussions with the customers, all point to the strong sense that the second half of the year, we could begin to see a return to more normal pickup in demand.

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

Got it. But it wasn't anything like inter or intra-data center delineated. Just kind of overall expectations that it paused and kind of resumes in the second half.

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

Mostly, mostly, intra-data center.

Operator

Your next question comes from the line of Dave Kang from B. Riley FBR.

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

My first question is regarding the Android win. Chuck, I believe you said it will ramp in 2020. I may have missed it, did you say it's fiscal '20 or calendar '20?

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

Calendar '20.

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

Got it. And then on the Redstone, Mary Jane, I think you said -- how much did you pay for Redstone? I think I missed that number.

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

$29 million, $30 million, 3-0.

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

$30 million. Got it. And can you just provide like the revenue run rate and margins and whether it's accretive or neutral. Any color on those topics?

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

It's a pretty small acquisition, we're not going to disclose that.

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

It's a small but strategic. And Dave, I don't know if you were on the call, I repeat it,both combined with the earlier smaller acquisition that we talked about in the past, I'm expecting that they will be accretive to our rapidly developing roadmap in high-energy lasers for our aerospace and defense business and could contribute at least $200 million of revenue inside the next 5 years.

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

Got it. And then my last question is, once again, going back to the ROADM products that was up 80% year-over-year. How did they do sequentially? And then how should we think about their growth in fiscal fourth quarter. What's baked into your fiscal fourth quarter guide, that's my last question.

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

Right. I would say, first of all, with respect to ROADM components as a general matter, it was a pretty decent sequential growth. And I'd say with respect to Q4, we have certainly baked in some growth compared to last Q4, but as you know, we actually don't detail the guidance by end market. But generally speaking, I would say, we've seen a full quarter's here of the optimum communications market picking up and we expect to see that continue.

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

Yes. I would just add, Dave that, as I said, we're sold out. And so our ability in Q4 to expand much output is tied to the -- our ability to generate, as Gary said, maximum utilization of our facilities. So really we're taking stock now of our requirements in the second half of our calendar year as we think about our fiscal year '20 budget as a standalone II-VI before the acquisition. But we're in a spot where we're working vigorously to reduce our cycle times, break the constraints, work the supply chain. When we're in a sold-out position, there's not too much more output that we can get from the facilities we have.

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

One more question, if I could. I believe you said, Chuck, that or, Mary Jane, that as far as our communication strength, I was mainly driven by China and India. Obviously, you don't sell directly to India, I assume you sell through what Chinese customers like Huawei, for example?

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

Well, Dave, we were asked a question about geography, that's why we answered it that way. And our channels into the market, as you know, we sell components to devise OEMs and particularly components into network equipment manufacturers. And those network equipment manufacturers are the largest in the world and they address the markets in all of these geographies, as you know.

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

Dave, just so we're together, my comment was that the growth in the quarter was a big contributor from China as well as Japan, a little bit lesser from the U.S. market, but the actual absolute revenue in the -- was very, very good from the U.S. market. It's just the U.S. market has actually been the one that has been stronger all along.

Operator

Your next question comes from the line of Richard Shannon from Craig-Hallum.

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

Just a question on gross margins here. Obviously, that has been down for a few quarters here. About a year ago, you were doing 40 and even early last year, you were a little above 40%. How should we think about a path back towards that? Maybe if I can ask kind of sending some of the information you gave earlier in the call, I think you said 3D Sensing was about a $0.06 impact, if I assume that's all in gross margins. That would get us a little bit more than 100 basis points back from that. I'm assuming Photonics mix is another impact, but Chuck, maybe you can help us understand where do you think getting back to 40%, obviously, excluding the potential acquisition of Finisar that that can be a reality for you?

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

Yes. I think, first of all, you're well on the right track there, which is the gross margin is affected by full utilization of our -- of the assets. So 3D Sensing was one of the major contributors and as I said earlier, is probably the largest contributor in the gross margin going down. At the same time, in the development of the new products, while the bulk of the money to develop new products and designs within R&D, of course, they do manufacture -- do develop products for manufacturability, which means that they also sometimes use time on the lines and that can have a little bit of the dampening effect on the gross margin. Generally speaking, I would say that there's a little bit of dampening across Performance Products too from a gross margin point of view, but I think that's actually more temporary.

So I think, generally, our Performance Products teams, many of which, if not all of which, the divisions are doing well, getting back onto their stride from Q3, 3D Sensing picking up and then industrial recently. And keep in mind that as we've often said, the margins for industrial products and grown materials tend to be higher than the corporate average. So a little bit of our kind of flattish performance on the mix was optical communications picking up is going to affect the margin a little bit. And I think when they're all up and growing, which has happened quite a bit over the last 3 years, I think we'll see the margins resume.

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

Okay. Fair enough. Question on ROADMs. Maybe I'll ask you more directly than one of the prior question here, but -- I think you're talking about 80% growth here and there in the ROADMs in the March quarter. What would that number have been without CoAdna?

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

Oh. I'd say it's probably still pretty decently up -- hang on a minute. Ask your next question, I'll look at it for you.

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

Okay. And then I guess a follow-on and within ROADMs and I'd like to talk about this organically excluding CoAdna as well or if you want to blend this somehow, but how should we think about kind of unit growth versus content in ASP growth within that ROADM bucket going forward?

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

We got, Mary Jane.

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

Well, first of all, I think the growth year-over-year still would have been very, very good without CoAdna and probably not too far off without CoAdna because obviously, within the second quarter sequentially. So it would -- it would have been still quite strong. I would also say that with respect to your question on AST, I mean the communications market has the most ongoing pricing pressure of all the end markets, ROADM probably with possible exception of consumer. And because I don't think the market is fully utilized at this point, I think, we expect to see those dynamics continuing before they potentially mitigate a little bit going forward.

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

Yes. I would like to add now regarding CoAdna. Mary Jane's absolutely right. It was still -- would have still been very strong of its own, right? But this portfolio that CoAdna have and their ability to excite the people who are designing 5G systems and 5G infrastructure, especially in China, is really exciting and is a great complement to a high port switch that existed Finisar as we look forward. The -- our ability to serve other components around the WSS is really also the strong part of our overall strategy, and it remains really, really exciting. I also want to say, the team's done a great job. CoAdna is fully and completely integrated into II-VI. And they've really done a fantastic job. Okay, sorry. What was your next question? I'm sorry, go ahead, Mary Jane.

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

No, I'm sorry. I was asking you did we get all of your questions?

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

Yes. I think you did. I'll have one last question get aligned here, just related to the Redstone acquisition, I guess, more specifically about the high-energy laser market charge you mentioned kind of $200 million bogie over the next five years. When do we start to see first contributions that within the 1- to 2-year time frame or is that a little difficult to predict?

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

Well, as Mary Jane said, it's a -- Redstone is a small strategic acquisition but is on the radar screen at every one of our large aerospace and defense customers. They know them -- they have known them and known them even better than we do. And their products are highly differentiated. They are being designed in. There's a strong demand for more and so we will work with that great team at Redstone to accelerate the deployment and the expansion of their capability. It will be slow because the design work and the ramping will take us a little bit of time, but once it all gets into a spot where our customers are happy with our capacity plans, I think it will take off. And I'm counting on it, and thus I gave you a sense for that inside our long-range plan, which is unusual because I generally don't do that, but I'm really excited about it because this is 1 -- this is 2 actually that are sold strategic and catalyze our position in the supply chain in this market. We are extremely well differentiated and positioned in my opinion. And I'm really excited about it.

Operator

(Operator Instructions) Your next question comes from the line of Paul Silverstein from Cowen.

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

And I apologize, there's been some connectivity problem, so Chuck and Mary Jane, I apologize of this asking, repeat yourselves. With respect to the overall comps business, I host in different things this morning and I want to make sure I understand, it sounds like the overall business was and remains very strong. Is that accurate?

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

Yes.

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

Yes.

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

Right. And Chuck, I listened, you said that your capacity constraint sold out ROADM's. Any idea how much revenue you've left on the table?

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

Actually, I think, no. I mean, first of all, several other components that we have, we worked to keep just a little bit capacity constraints because this is one -- optimum communications is one of the most volatile markets, obviously, in the II-VI portfolio. We have seen some really outstanding work by our teams when the demand has presented them to increase their production in various ways, whether it's running longer ours, changing the shifts, and releasing bottlenecks, et cetera. I am sure that they will to a very, very good job on their delivery for Q4 and I think compared to last year, we'll probably see some nice growth. I think Chuck was specifically talking about sequential.

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

Yes. And I -- it's a real good question, Paul. It's not an easy one to answer, but in direct communications with the customers, I believe that our products are designed into sockets, differentiated and our task is to not focus on that, but our task is to be able to break the constraints. And I have committed to them that we'll do everything that we can to do that even within the quarter and work with them to reschedule shipments as early into the first quarter of fiscal '20 as we possibly can. There's just an awful lot of collaboration happening right at the interface with the customers to make sure the timing is the best it can be. And we have to stay focused on that because people are needing what -- more of what we make. And that's really a great position to be in what we have a responsibility to even better in what we're doing and we're working toward it.

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

And Chuck, did you comment on your 980 pump business?

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

No. It's up to say that our portfolio of ROADM Products, including our pumps, is extremely high demand. And what I didn't say, what I could say, is that just to come back to the widespread deployment of submarine networks. Our 980 pump business for the submarine market is also continuing to grow. We have one new sockets at new accounts and those accounts are expanding their demand in the third quarter, it was good in the fourth quarter, I'm expecting it will be even better. And by the way, for the submarine market, if I didn't say, I'd like to say there's a CoAdna team that has done an extraordinary job and we now have our first Wavelength Selective Switch qualified for the submarine network, really exciting.

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

All right. One last question for me. If I can return to that regional discussion, I was a little confused. I thought, Chuck, I heard you say that U.S. was weak and then I thought I heard Mary Jane say that U.S. was strong. Can you just clarify?

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

I'll just say, what we say, first of all, North America, we have really, really important customers in North America and we're focused on serving them and it's been stable, it's been strong, particularly incoherent and it was offset, I said by slower than usual demand from the cable TV and fiber D people because there's a large acquisition integration that's taken place, but we are very bullish about cable TV and fiber deep architectures. We have been in discussions with the leaders in North America. We think that that's going to be a good long-term opportunity for us and what I said was in Europe and this, we've had slightly softer sales, but the demand particularly driven by 5G is increasing coming from our European customers and as part of our capacity for drive through our adding in capacity for 5G. But in general, the strongest overall demand has been from China and in India in our customers there.

Operator

We have a follow-up question comes from the line of Tim Savageaux from Northland Capital Markets.

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

Appreciate the follow-up. And 3D related questions here both with regard to kind of current revenues and expectations. First -- and Chuck, I think you'd mentioned some sequential growth on the industrial side. Can I infer from that that Laser Solutions grew sequentially in Q3, ex 3D Sensing, or no, that's kind of a short-term 3D-related question? And then, one kind of medium term. I wonder if you might -- you mentioned gearing up for the second half ramp, kind of, in the new product cycle. I wonder if you could characterize that ramp at this point with relative to what you saw last cycle. Do you expect growth, I guess, over what you saw last cycle? And I think in addition to the Android win for 2020, Giovanni made the comments about second half '19, design wins that I'm not sure I caught on the 3D side. Did you mean to imply some additional revenue drivers in the second half of calendar '19 outside of the main product cycle?

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

All right. First of all, Laser Solutions did grow up in 3D Sensing and then with respect to 3D, Giovanni.

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

Yes. We expect to see the same pattern that we saw last year, but I believe, we'll be a little bit -- we'll be higher than last year. I think we -- as we said, we're going with multiple designs and we should be in a better position than last year, but the -- seasonally, the pattern will be very similar.

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

Were there any other portions to your questions there, Tim, we didn't get?

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

I think we hit it.

Operator

I'm showing no further questions at this time. I would like to turn the conference back to Mary Jane Raymond for closing remarks.

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

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Thank you, Lance, very much. I'd like to thank you all for joining us today. And we look forward to speaking to you when we come to our full year, fiscal year '19, year ending call that is now scheduled for Tuesday, August 13, 2019, at 9:00 a.m. Thank you very much for joining us and have a great day. See you soon.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation, and have a wonderful day. You may all disconnect.
