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IIVI - II-VI Inc at JPMorgan Tech/Auto Forum at CES

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CORPORATE PARTICIPANTS

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

CONFERENCE CALL PARTICIPANTS

Samik Chatterjee *JP Morgan Chase & Co, Research Division - Analyst*

PRESENTATION

Samik Chatterjee - *JP Morgan Chase & Co, Research Division - Analyst*

Good afternoon. This is -- I'm Samik from JPMorgan. I cover some of the network equipment names and hardware names. The next company presenting for the fireside chat is II-VI. We have Chuck Mattera, the CEO, with us. So Chuck, maybe just to -- in the interest of time, because we have 30 minutes here, if you can just kind of introduce the company just for investors who may be newer to the space in terms of what the company does and a bit of history, and then we can kind of start off with more direct questions in terms of the business segments.

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

Okay. Good afternoon, everyone. Thank you, Samik, for your invitation and remarks. I'll go fast, so we can get right into the questions. II-VI is a company founded in '71. It'll be -- turn 50 years old on July 1, 2021, went public in '87, with \$10 million in sales. We are an optoelectronic materials and -- engineered materials and optoelectronic device company. We operate in 8 major markets. 7 of them are commercial markets. The largest one is communications, optical communications. And the noncommercial market is the aerospace and defense market. We have been an innovator in lasers, optics, and now with the acquisition of Finisar under our belt, and we're also -- have the capability to integrate lasers, optics and electronics. We're coming into our 50th anniversary in the next less than 2 years with an awful lot of momentum. When I joined the company as a Board member in 2000, revenues were about \$75 million, 1,000 employees. We're on a run rate to do roughly \$2.5 billion in annualized sales plus with about 24,000 people. And we are a market leader in most of what we're presenting to the market. So I'd like to get into it right away.

QUESTIONS AND ANSWERS

Samik Chatterjee - *JP Morgan Chase & Co, Research Division - Analyst*

Yes. No, that's a good start. So let me -- so we're discussing this outside as well, Chuck, when you were here last year. You had just announced the Finisar transaction at that point. And the questions from investors were more around the rationale for the acquisition. I think the conversations at this point are more around where are you in the integration phase with Finisar, what are the priorities as we look into 2020, what are the priorities in terms of that integration so that when -- how are you thinking about maybe the synergies as well. So maybe just walk us through that.

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

Okay. We're really excited about it. We announced in November of -- 2 Novembers ago. We had, had some time to both do our diligence and to plan the largest acquisition in our history, combining 2 companies of roughly the same size. July 1, well ahead of the finalization of the deal, we moved II-VI into a new organizational structure to get ready to accommodate so that we could move quickly and gain the scale and be able to simplify the structure and deliver the synergies. And we hit the ground running on the very first day of the deal.

So I'm very positive about the deal and the integration progress is really fantastic. Our excitement for the combined company has only increased since day 1, especially given the size, the large number of large customers that we have in the company. Nevertheless, our priorities are aligning our resources with those of those largest and the fastest-growing customers and being able to generate a time-to-market and time-to-volume and



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scale advantage for them, accelerating new product introductions, driving sustainable operating improvements and aligning our costs with market realities while delivering the synergies. And then finally, working an ongoing process for efficient capital allocation and cash management.

Samik Chatterjee - JP Morgan Chase & Co, Research Division - Analyst

Okay. So maybe if we -- in light of that, I mean, the transaction between II-VI and Finisar was one of the many transactions we've seen in the space. And we've seen a wave of consolidation in the optical component segment itself. So if I ask you to kind of put your long-term hat in terms of thinking what the implications are long term for the industry from this, how are you thinking about kind of how the industry structure changes or the dynamics of the industry changed because of this wave of consolidation that we've seen?

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

Okay. Let me take a step back, take you back to January 2010. That's 10 years ago. We're just about ready to celebrate our tenth anniversary of the acquisition of Photop in China. That's -- that was our foray into the optical communications market and the establishment of a broad-based platform to grow from in China. That -- at that time, we were #26 in terms of our size and service of the optical communications market. With the closure of the Finisar acquisition, II-VI is now #1. We're the largest optical component company in the world. We believe consolidation is good for the industry overall. People have been talking about it and working at it for 20 years. We expect it will ultimately drive greater efficiencies in the time it takes to bring things to the marketplace.

We also see the traditional value chain boundaries shifting, and we see quite a few companies either backward integrating or forward integrating. We see that less of a threat, although we're aware and keeping our heads on a swivel. But now, we view that as opportunities for us at multiple levels of the value chain, including in materials, components and then subsystems. Those are the 3 levels that we like to segment the market or the markets and differentiate ourselves and address.

Samik Chatterjee - JP Morgan Chase & Co, Research Division - Analyst

Okay. So before I move into the segments itself or the individual segments, one question that I often get from investors, and this is particularly from new investors coming and taking a look at II-VI, is kind of give us the 2 or 3 big reasons or big drivers of revenue of why we should be owning II-VI here. And as you just mentioned, you have 8 different kind of market segments that you are in, which kind of is sometimes a bit more complicated than what the new investor wants to look at. So as you look at the next 4, 5 years, which are the primary kind of drivers of revenue that you are focused on that are the reasons that investors should be owning II-VI stock?

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

Okay. Well, each business in the company, every business, every product line manager, every platform manager has an obligation and they drive to grow. So profitable revenue growth is a requirement for everyone, but I'll highlight 4 today. The electrification of the car is a -- what we believe will be a huge opportunity. Once the -- we're past the inflection point, but once we get up to a little bit closer to the big inflection point in the S curve, we think it's going to go on for a long, long time. As the world looks to reduce carbon fuels and fossil fuel emissions, this will be a major priority by legislation. It's already starting into the marketplace. And there's a value proposition for silicon carbide-based power electronics that's unequivocal and irrefutable, and we're really excited about that.

Regarding the fifth generation of wireless communications, including for providing services -- valuable services for autonomous driving networks, 5G is among the largest markets for us, and it is the most pervasive. It means the most addressable by many of our businesses inside the company. We're aiming to have a substantial content from the cell tower through the front haul, the middle haul, the access, the metro, the long haul and the submarine networks. It's going to get -- all get tied together by optical communications and GaN on silicon carbide HEMT devices, we believe.



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The third one around 3D Sensing, and 3D Sensing will include a deployment and an adoption, we believe, around autonomous driving because for 3D Sensing, we see demand in consumer electronics as well as LiDAR, ADAS and even in-cabin monitoring systems coming. Our opportunity in 3D Sensing, we believe, extends well beyond VCSEL devices to VCSEL-based modules and high-power pulsed laser transmitters, optics, filters, windows, lenses, everything we do, especially for LiDAR. So this is the third one.

And the fourth one is one that most people generally don't connect us to, but it's been really important at our core and it is coming to the forefront on the basis of the adoption of high energy lasers for high-energy laser weapons. And that's our aerospace and defense business, which has had its core in electro-optic materials and components for -- in very strategic applications like intelligence, surveillance, reconnaissance and targeting. And now with the acquisition of Finisar and the technologies that we have inside the company for lasers, optics and ICs, we see a great opportunity ahead of us in the satellite communications market, both commercial and aerospace and defense.

So as the world looks to deal with new and evolving threats and moving away from active engagements of human beings, our capabilities for high-energy laser-based components and subsystems, we believe, will be a key differentiator for our U.S.-based customers.

Samik Chatterjee - JP Morgan Chase & Co, Research Division - Analyst

You mentioned you're the leader when it comes to the optical component industry at this point. But that's after a range of acquisitions that you've done over the past few years. As you look at kind of the differentiation that now II-VI has related to the wide kind of competitive landscape that you generally always kind of run up against, where is the differentiation today? Is it manufacturing? Is it IP design? Or is it just the broader scale? Like, how would you define the differentiation that II-VI brings?

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

Okay. It's really a great question. And for II-VI, it is really simple to understand once you get to know us. Our fundamental view of the world comes through engineered materials. We are an engineered materials company, and we focus our competencies on providing sustainable competitive advantages for us, allowing us to innovate at the core of the functionality of our products and to provide customers with -- not only with differentiated, vertically integrated products but engineering materials with a competency that's unique and generally not available or accessible to our customers. Second is our large and growing customer base, where our deep intimacy and our privileged access to information from our customers gives us a differentiated ability to understand many of the possible and planned new applications, which will allow us to diversify our end markets and provide operating leverage around our investments, while dampening the effects of market volatilities across some of the markets that may happen.

Samik Chatterjee - JP Morgan Chase & Co, Research Division - Analyst

Okay. So let me get into one of the key markets here, which is telecom. And given the focus on the telecom side with 5G ramping here, just maybe take us through, one, which stage of the 5G investment cycle on the telecom side from service providers do you think we are at right now. And how is the acquisition of Finisar either adding or kind of even if it doesn't impact, like how is that providing synergies as you look at the leverage to the service provider spend on 5G?

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

Yes. I'll repeat, Samik. I believe that the 5G market itself is one of the largest opportunities we have in front of us, and it's just beginning to take off. And I can't be sure if it'll be 3 to 5 years or 5 to 7 years or 7 to 10 years, but it feels like it's going to have a long-term run to it. We have, as I said, content from the cell tower to the core network. We're extremely well positioned in transmission, amplification, switching and monitoring. We are a full line supplier to people who are building out 5G wireless networks. With the acquisition, we gained the transceiver technology, which provides among the largest opportunities for us within 5G. For example, we believe that the TAM, the total addressable market, just for front haul transceivers for 5G will range somewhere from 70 million to 240 million units in the next 10 years, up from about 4 million units today.



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In addition, given the diversity of the link types on the basis of architecture, country deployments, we believe that there'll be a variety of transceivers required and only a company like ours, we believe, that has both the competency, time to market and the scale can provide the kinds of turnarounds that people will need.

Also, we acquired an indium phosphide-based laser capability as part of the transceiver business at Finisar. We believe that, that business is among the most differentiated businesses in the world in the marketplace. And with regard to tunable indium phosphide lasers, we believe that we are 1 of only 2 suppliers in the world capable of producing those lasers for these applications. So we're really excited about it.

Samik Chatterjee - JP Morgan Chase & Co, Research Division - Analyst

Right. You're bullish on 5G, but what we generally see at this point is if there's kind of skepticism or risk around 5G and kind of the trajectory that it has, a lot of that stems from kind of the view on China and how people kind of bucket in terms of the opportunity as well as the risks around China's deployment of 5G infrastructure. Where do you stand on that? How do you think the trajectory of 5G investments in China will track from here on? And do you see any associated risks with that deployment pace?

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

Well, we announced -- in November of '18, we announced the construction of a large-scale manufacturing facility expansion in Fuzhou, China. We expect for -- to accommodate what we expected would be the huge increase in demand. That facility and its satellite facilities are sold out already. The opportunity that we have and that we see in the initial deployments of 5G in 2018 calendar year and what we expect in 2020 calendar year are significant and substantial. While China is 22% roughly of our combined company's revenue and it's an important growth market, we've invested ahead of the 5G ramp to enable customers worldwide to win, including those inside China and outside China.

We remain bullish about the China 5G market opportunity. We will continue to offer expanded capacity not only from our new facility in Fuzhou but capacity expansions in our facilities in Vietnam and in Malaysia. And although we don't expect it, if the China market were to temporarily slow, we would retool our assets and our manufacturing lines and compete effectively to address the other opportunities.

Samik Chatterjee - JP Morgan Chase & Co, Research Division - Analyst

Okay. Getting into another opportunity that you mentioned, which is silicon carbide. And you mentioned power electronics in the car being a big opportunity on -- with silicon carbide. There's obviously the RF opportunity as well. So maybe help us understand the magnitude of the opportunity, but also how you're thinking about magnitude between car -- the automotive and the wireless side, and the timing of each of those coming to fruition here.

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

Okay. It's really another great question. We've been investing in silicon carbide substrate materials for more than 20 years, the technology. Our first phase was focused on the RF market, the semi-insulating silicon carbide for RF applications. And I would say that most of the first 10 or 15 years' focus was on that. Our technology platform is scalable to the electronic device materials capability as well. But the wireless market for us turned on first. We think the wireless market itself for silicon carbide substrates is about \$500 million. And we announced a little over a year ago a partnership with Sumitomo Electric for the production of GaN on silicon carbide HEMT devices, which we expect to be in manufacturing by the end of this calendar year. And we believe that market is about \$1.5 billion. It's widely addressed by silicon LDMOS, but in the last 3 to 4 years or so, we believe that GaN on silicon carbide has penetrated that market much -- at a rate much faster than the market growth itself. And we think it's really exciting, and we think that both 4G and 5G wireless base stations are a key part of the demand.



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Samik Chatterjee - JP Morgan Chase & Co, Research Division - Analyst

Got it. So obviously, that's a positive. If we kind of then go down the path of things that were kind of weak in 2019, particularly the industrial market was quite soft and even kind of looking at it right now, there seems to be pretty less visibility at least from an investor standpoint as to what happens with that market in 2020. So what's your latest take on that? What are your expectations for growth in the industrial market segment as you look into 2020?

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

Yes. Well, we experienced a slightly down year for our industrial businesses in our calendar year '19. We have to take that head on. When the markets go down, we have to pick up our pace because we need to grow. So we need to get more aggressive, more competitive and figure out how to grow even in a declining market. So the whole place is geared for that.

However, we have seen some recent recoveries led by some of our Chinese and some of our U.S. customers, and we're hopeful that the market would begin to turn around mid-calendar year 2020. We think the rapid decrease in the automotive market in China that was reported from September of '18 to September of '19, we believe that, that's slowing down. And the Caixin PMI index for manufacturing in China in the last 3 or 4 months has had 1 positive uptick after another, and we're optimistic about that.

Samik Chatterjee - JP Morgan Chase & Co, Research Division - Analyst

Okay, got it. Moving then to another aspect of the business, which was weak as well and has been more in focus with the acquisition of Finisar, which is the datacom market, particularly with -- exposed to the hyperscale cloud customers. What's the -- I mean, we've seen similar acquisition and somewhat a similar approach from Lumentum, which acquired Oclaro and they went on to rationalize that business a bit in terms of balancing profitability and revenue growth, just given that it's not exactly the easiest of markets to operate in. So as you look at integrating Finisar, how are you thinking about kind of creating that datacom exposure in terms of how do you balance profitability and revenue growth at the same time?

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

Okay. It's really another great question. We're now the largest datacom transceiver maker in the world. I just pointed out to you an enormous TAM associated with the 5G wireless market that would be difficult for anybody to identify as anything other than attractive market to be able to play in and to figure out not only how to generate revenue but how to be profitable at it. We believe that recent announcements of a couple of large companies who are in the process of acquiring transceiver companies or reacquiring transceiver companies underscores the importance of the integration of lasers, optics and electronics.

Our strategy is really twofold: one, to focus on higher speeds, higher-end performance, higher-value products and to differentiate them from low-cost integrators. We have a large position. If you have a small position in the transceiver market, it's easy to walk away from. We have a large position in the market, and we're excited about figuring out how to continue to grow it. And at the same time, to adopt a second pillar of our strategy that Finisar did not have or did not choose, and that is to be a merchant supplier of components into the transceiver market, whether it'd be to sell lasers, photodetectors or even ICs, which we believe represents an incremental addressable market of about \$1.5 billion or more. And even though we did not justify this investment on the basis of revenue synergies in the most recent quarter, while we've engaged customers and their interest and inquired with customers in their interest in becoming a merchant component customer of us, I can assure you that there are a lot of very excited people who are interested in buying components from us, for which we will compete with at the transceiver level. But we ordinarily, and as a practice, we have addressed the marketplace at 3 levels: materials, components and subsystems. We view it as an opportunity, and we're going to stay focused on it. Okay?

Samik Chatterjee - JP Morgan Chase & Co, Research Division - Analyst

Okay. Let me check if anyone in the audience has a question. Yes, go ahead, [Rick].



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Unidentified Analyst

(inaudible)

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

Yes. We have a -- we have, first of all, is an engagement of the management team and the CEO and CFO and the Board. We have a very disciplined process about 5-year planning and in-year budgeting, and there are guidelines, targets, expectations for returns on invested capital and internal rates of return that have to be met. And we have a different set of rules or platforms that may cut across the whole company or take a little bit longer to mature than we do on products that are here and now for which we only need capacity expansions. And I think we've done a real good job of that. In the process, we're pulling Finisar and the business units of the former Finisar into and under the same umbrella.

Samik Chatterjee - JP Morgan Chase & Co, Research Division - Analyst

Chuck, let me jump to a topic that I think we need probably best to address before the time runs out, which is the execution issues in the Sherman plant. So where do we stand today on the ramp issues that you were facing at the Sherman plant. I think, publicly, you've communicated kind of getting them fixed by March. So if you can just give us an update on that. And how comfortable do you feel being ready for the next product cycle for the primary customer in that 3D Sensing space that everybody is targeting?

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

Okay. I appreciate it. I'd like to -- I'll come right to it in a second. But I'd like to give you the backdrop that we believe that the 3D Sensing market today is still just getting underway. And although it represents less than 5% of our combined legacy Finisar and II-VI revenue, we've been shipping in large volumes for the last 2 years from our Warren and Easton, Pennsylvania facilities. And we're working hard to enable us to ship from Sherman beginning in the March quarter.

The experience that we've had in Easton and Warren, they have led to what I consider to be world class, extremely competitive from a volume, yield and reliability point of view and the teamwork and experience that we've established there, I believe, is helping and will continue to help the team based in Sherman, who have really good ideas themselves and really good capabilities in combination, I think, long term, is going to allow us and enable us to be extremely well positioned. All I can tell you is, as somebody that's been working and running these kinds of fabs for 36 years, you need a game plan. We're following the game plan. And that game plan is allowing us to assess the gaps along the way and to work quickly to close them. And I expect that when all is said and done, we'll be well positioned for the long term. And I have no information today to lead me to believe that we won't be able to or ready to by the end of the March quarter, as I said in November.

Samik Chatterjee - JP Morgan Chase & Co, Research Division - Analyst

Okay. Let me then end with the easy one for you. Generally, in your communication with investors, you don't focus a lot on the defense business, so the really -- or the military business, whatever you want to refer to it as. How -- I mean, the question we get from investors is how can they get visibility in terms of the growth in that segment continuing at the robust pace that you've seen over the last few years. What can you provide in terms of visibility, either be pipeline or kind of the award wins to assure investors that the strong growth will continue for a few years?

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

Okay. Well, the -- we have 2 operating segments in the company today. The aerospace and defense business is set into one of them, the compound semiconductor segment. We are not going to break out the financial performance of any of the business units inside the segments. What I can say is that we announced in the last 18, 20 months a couple of relatively small acquisitions that were poised and absolutely keystones for our overall



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strategy to deliver semiconductor laser-based and high energy laser-based technology, optics, beam combining and targeting and pointing capabilities and beam delivery systems. We have those under our roof today. And the demand for those capabilities and the engagements that we have by way of design ins, design wins and ramps and the 5-year forecast we have for those is extremely exciting. We -- that business, we generally start the year nearly fully booked. So we have a strong backlog, generally speaking. Our bookings have continued in the last couple of quarters to increase. This is a time when our differentiated technology is beginning to hit an inflection point, and it's really an exciting time for us. I think it's going to continue to grow and will continue to be, as I said, talking about among our top 4 priorities, including of the CEO, this is one of them.

Samik Chatterjee - JP Morgan Chase & Co, Research Division - Analyst

Great. That's all the time, but thanks for coming to the conference. Thanks for participating. Thank you all for coming.

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

Thanks, Samik. Thank you very much, Samik.

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