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IIVI - Q1 2020 II-VI Inc Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the II-VI Incorporated FY '20 First Quarter Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions) Now I'd like to hand the conference over to your first speaker today, Ms. Mary Jane Raymond, Chief Financial Officer. Ma'am, you may begin.

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

Thank you, Paul, and good morning. I'm Mary Jane Raymond, the Chief Financial Officer here at II-VI Incorporated. Welcome to our first quarter earnings call for fiscal year 2020.

With me today on the call is Dr. Chuck Mattera, our Chief Executive Officer; and Dr. Giovanni Barbarossa, our Chief Strategy Officer and the President of the Compound Semiconductor segment.

This call is being recorded on Tuesday, November 12, 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 it over to Dr. Chuck Mattera. Chuck?

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

Thanks, Mary Jane. Good morning, and thanks to everyone who are joining us today.

Before we begin, I would like to take a minute to thank all of our veterans as they remind us of the importance of dedication and determination over the long haul and II-VI's strategic position in the aerospace and defense market.

As we have many times in the past 20 years, we have started another new chapter in the evolution of II-VI. On September 24, we closed the Finisar transaction, the largest acquisition in our history. Our excitement has only increased since day 1 as a result of the complementarity of the technology and manufacturing platforms of both companies. Despite some market pauses commensurate with our conservative case and the normal heavy lifting that is needed in the time immediately after an acquisition, we are confident that we will disrupt the status quo.

As a result of the acquisition, we are the largest component and subsystem supplier in the global optical communications market and, we believe, the undisputed leader in Photonic Solutions and Compound Semiconductors. The combination of the semiconductor laser, customized optics and integrated circuit technologies, along with the miniaturization and automation platforms of the new company, position us well to expand into a larger portion of each of our end markets.

For example, we fully expect our industry-leading indium phosphide laser capabilities to enable rapid growth across multiple markets, including optical communications, automotive, hyperscale data center communications, life science diagnostics and consumer electronics applications, to name a few.

Moreover, we believe that increased scale and quality will ultimately yield lower costs, greater competitiveness and result in more ubiquitous adoption of scale. In fact, we are already seeing tremendous growth in our indium phosphide-based coherent products. Our recent innovations in highly integrated indium phosphide laser components and analog integrated circuits have propelled us into a leading position for the latest generation of 100G, 200G and 400G pluggable coherent transceivers. In fact, we've already had multiple design and engagements for the coherent opportunities before us, and we are committed significant resources in order to intersect the market and establish a strong #1 position.

Our investment focus is being guided by our broad customer base with whom we have over 20 active design engagements. We expect to see meaningful revenue and profit off-site in both FY '20 and '21. This differentiated platform for coherent products will help offset the fact that the Datacom space is in the low part of the cycle as Web 2.0 players prepare for a technology change. Combined with our coherent transceiver innovations, our high-speed VCSEL know-how will help spur growth in the next transceiver upgrade cycle in data centers from 100G through 400G and 800G, which Giovanni will discuss in more detail.

We are continuing to work at expanding the number of new opportunities that we can address from our 3D Sensing VCSEL business. I have spent a good deal of my personal time in the last 6 weeks communicating with customers and employees to understand the capability and readiness of the operations at the Sherman, Texas plant. That facility is the newest and largest of the world's Compound Semiconductor fabs known to us.

During my visits, I found a well-equipped, world-class wafer fab, substantial and sufficient in-house MOCVD epitaxial growth infrastructure and capacity and a market-leading development team well positioned for the next generation designing cycle currently underway.

Although the fab was qualified in the September quarter and was well positioned to begin buying shipments in the December quarter, a technical issue required some additional attention and that work is causing a delay. We are working closely with our largest 3D Sensing customers to implement and to qualify the improvements that have been identified, and as of today, our conservative view is that we will begin shipping in the March quarter.

We are actively sharing best practices between the fabs and expect the benefits of that synergy to quickly accrue. We are accelerating the improvements through the final stages of the approval process. In the meanwhile, we have been asked to ramp up the capacity and shipments from our Houston, Pennsylvania and Warren, New Jersey fabs over and above our forecast and that is going extremely well.

With respect to cost synergies, we got off to a very good start at the crack of the bat. Our preclosing integration planning work allowed us to hit the ground running on the first day of the combined company. At this point, we have a very robust process underway for the supply chain synergies, the largest portion of our identified $85 million of cost of goods sold synergies over 3 years.

Our new Chief Sales Officer is also working with his team to identify revenue synergies, which will be accretive to our total $150 million 3-year cost synergy projections from both the cost of goods sold and OpEx. Customer engagements have remained very positive and in discussions with them, we sense that momentum is building at our key accounts.

At the OpEx level, we've already achieved a good part of the synergies associated with corporate costs, including the elimination of the duplicated C-suite personnel, insurance, audit fees and directors' fees, to name just a few examples.

Regarding the order to hold separate the Finisar WSS business, we believe that the market-leading potential of the combination of II-VI and Finisar WSS caused China's regulators to rule that they be held and operated separately to preserve competition. Our revenue plan has already been submitted for approval and we look forward to both of our WSS teams thriving as the market grows.

Now I would like to make some summary comments to tie it all together. I am more confident than ever in our ability to enable our growth, driven by the long-term megatrends in our markets, including 5G wireless, cloud computing, optical communications, 3D Sensing and electric vehicles. Our strategic plan calls for us to leverage our broad innovation and technology advantages, which along with our unique insights into markets shifts, will drive significant long-term value creation through a much larger customer outreach, increase global scale, expanded and complementary product roadmaps and existing leadership positions with the largest customers in our fast-growing markets.

We now have over 10,000 customers and as many reasons why we are optimistic about the future. In fact, the confidence of our top customers whom we serve, which are expected to account for over $1.5 billion of annualized sales, are excellent reminders that the potential power of this platform. We look forward to their being great partners with us in our future growth plans.

Looking back, we worked on the planning and integration details of this strategic acquisition for 2 years leading up to the close in September. We acquired Finisar to increase the number of our technology platforms and expand our addressable markets while filling our broad objective of enabling the change that the world is experiencing today as it becomes more connected, intelligent, mobile and electric.

It is especially important to note that since we announced the acquisition over a year ago, changes in market conditions brought on by the side effects of a protracted trade dispute, a slowing industrial global economy, a down market cycles associated with the adoption of new technologies, and some operational challenges have created near-term headwinds. This will require us to step up our efforts to get us onto a trajectory to achieve our long-range projections. Therefore, we will continue to further assess the business after operating it in its new structure for 1 to 2 quarters to define the gaps and the steps that we will take to simultaneously increase our top line and to align our cost structure with market realities. In the meanwhile, we will remain focused on executing our strategy, leveraging the technology, identifying and closing gaps step-by-step while working to improve our operating leverage.

With all that is going on, we clearly have rolled up our sleeves and are working to cover the ground quickly. We have some work yet to do to get ourselves to the extraordinary level of performance that we are capable of, and I'm looking forward to being able to report steady progress to you each quarter.

With that, I'll turn it over to Giovanni. Giovanni?

Giovanni Barbarossa - *II-VI Incorporated - President of Compound Semiconductors & Chief Strategy Officer*

Thank you, Chuck, and good morning. As a result of the combination of II-VI and Finisar, we expect to be ranked #1 in the optical communications component market. With the growth of 5G, which expands the world communication infrastructure from the tower to micro core and subsea networks, we are seeing increased demand across our vertically integrated value chain. For example, we are in a sold-out position in pumps and demands for submarine pumps alone now accounts for over $30 million of the backlog.

5G is also driving increased demand for coherent transmission. We have an exciting roadmap for coherent communications from components to modules and subsystems. As Chuck mentioned, we are in a leadership position for the next generation of highly integrated modules and we are already seeing a meaningful revenue this fiscal year with the forecast anticipated to generate a 10x growth year-over-year.

We are also very excited about our work with customers on component offerings that were previously captive within Finisar, including indium phosphide lasers, detectors, ICs and integrated optical subassemblies.

The laser device is for communications alone, will enable us to serve a total addressable market previously unserved by Finisar of $1.4 billion by 2023. The designing work will take a number of quarters though we're already shipping samples now. We expect revenue to begin to materialize in Q1 of FY '21.

For ethernet transceivers, those using data -- used in data centers, the market has been down about 15% from 2018 but we expect it to recover in calendar 2020 as we have multiple customer for (inaudible) underway for revenue in the second half of calendar of 2020.

While the mainstay products remain 100G, products for 200G, 400G and 800G will fuel new upgrade cycles in data centers. Our increased debt to empower development has positioned us well to go to market with the highest speed Datacom modules for hyperscale data centers. 5G is also the driver for gallium nitride and silicon carbide electronics in wireless base stations.

During Q1, we saw a rise in semi-insulating silicon carbide demand for wireless applications, even as the demand for conducting silicon carbide for power electronics temporarily diminished due to microeconomic conditions. The shift in demand required us to retool a portion of our proprietary [pharmacies] to address the surge in wireless demand. We expect that the introduction of 5G handsets will further accelerate deployments of 5G base stations worldwide, with China being the largest market in 2020 and growing rapidly in the next 3 years.

We recently introduced the world's first semi-insulating 200 millimeters silicon carbide substrate for RF power amplifiers for use in 5G base stations, complementing our 200 millimeters conducting silicon carbide substrates introduced 4 years ago. We also secured a $100 million sole source contract for our 150 millimeters substrates. We are in the process of securing a large scale facility in the Northeast for our projected 3 to 5x capacity expansion in the next 3 years for our market-leading silicon carbide substrates.

Turning to the industrial market. We saw about a 10% decline year-over-year, with most of the decline coming from China and Europe. Given that we are not only seeing adoption in new system sales but an overall drop in the GDPs of key geographic markets such as China, we are experiencing conditions that affect most of our industrial customers. This may persist into calendar 2020 though we believe that the long-term demand for laser processing of materials will return to growth, especially for innovative solutions that enable processing and higher laser powers and increased level of automation.

As a result, we continue to invest in our technology platforms. In fact, we recently released a line of laser light cables for ultra high-power laser safety certified over 26 kilowatts and received the first order for our 2D remote welding hub for automotive battery welding applications, enabled by our proprietary machine vision software platform for automated and unassisted seam tracking. We also announced the world's first-to-market aspheric sapphire lens for high power lasers, providing less focal shift than conventional lenses at ever-growing laser powers.

With respect to 3D Sensing, after 24 months in this market, we are well positioned for FY '20 to be a record revenue year. We believe that we are very well positioned for growth in the following years based on our share award agreements, vertically integrated 6-inch fab capacity in both Sherman and Warren, and our market-leading power convention efficiency of our VCSEL array.

We are engaged in a number of new opportunities for VCSELs in mobile devices for next year and we are seeing a lot of interest and activity in time-of-flight, 3D cameras for [world]-facing mobile applications. The leading Android vendors are moving for market testing the technology in select high-end model phones to offer in the technology and standard across multiple platforms as consumers see the benefits of 3D technology, especially input enhancement.

We are pleased to report the first shipment of our fully-integrated 3D Sensing module developed to address the need of some Android customers, and we look forward to beginning to gain share in that segment of the 3D Sensing market, too.

We are also seeing a strong interest in our VCSEL technology for 3D imaging and sensing in automotive, industrial automation and IOT. We are qualified in shipping to one large automotive customer for an in-car 3D camera across multiple vehicles and we are in active discussions with multiple automotive customers and supply chain partners who will be rolling out the 3D technology over the next 5 years. Safety standards are driving interest in and adoption of in-cabin driver and passenger monitoring, digital control and high-resolution 3D sensors external to the car for short range proximity detection.

Last quarter, we also certified our factory in Vietnam for automotive standards and we believe that the combined with the automation capabilities for our optical subassemblies, this capability will contribute to our competitiveness for subassemblies and modules for the market.

In addition to 3D Sensing, our Warren and Sherman fabs can address other markets reporting applications. In Warren, we are building out a 6-inch gallium nitride line as part our previously announced partnership with Sumitomo Electric Device Innovations, a leader in gallium nitride RF devices. In Sherman, the plan is to continue to produce high-speed VCSELs for the Datacom market, and we are proud of our team's accomplishment in demonstrating the first 100G PAM-4 VCSEL, which can serve the 400G and 800G market. We will leverage the former Finisar Datacom VCSELs and integrated capability to increase our sales in the component market.

Our Aerospace and Defense business grew 15% over the prior year period and represents 12% of our revenue in the quarter. We are making great strides into several new programs and remain strategic to our customers' existing programs. we are now engaged in 15 new programs with a portfolio of leading-edge technologies to precisely deliver high energy laser beams at the target. We also secured 2 key design wins in dome and sensor products for 2 multiyear contracts worth a cumulative $300 million in revenue.

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

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

Thank you, Giovanni, and good morning. So I'm going to do a few things this morning. First, I'll give you a few minutes navigation of the press release. Next, I'll review the highlights of the quarter and close with a discussion of the updated levels of key expenses, the progress on our synergies, the financing and the outlook.

So Table 1 on the second page of the press release, you will see the GAAP results, including 6 days of Finisar. Table 2, on the third page, walks you through the buildup of those numbers, starting with the operating results for legacy II-VI, the last time we will report results for legacy II-VI. So the comps across the top are legacy II-VI, Finisar for 6 days, severance and related costs, acquisition-related costs and then a subtotal column of all the special items of Columns 2, 3 and 4. The far right column shows the consolidated GAAP results.

Table 3 on Page 6 shows the segment results. The 6 days of Finisar are in a line called Finisar and Other. This is not to indicate that Finisar will be its own segment, because it will not be. The related nature of Finisar's operations to II-VI's operations results in the right treatment being to merge them into our structure once we see the dynamic of a full quarter.

Finally, Table 4 on Page 7 shows the non-GAAP margin results by segment. We can answer any questions you have on this format when we get to the Q&A.

The revenue was $340 million in the quarter, including $22 million from Finisar. Revenue growth was 8%, with organic growth at 1% compared to last Q1. EPS was a loss of $0.39 for GAAP and positive $0.57 for non-GAAP. Non-GAAP adjustments were $59 million on a pretax basis and $48 million on an after-tax basis. These are the adjustments triggered by the close.

In addition, legacy II-VI non-GAAP adjustments were $15 million, including about $5.5 million of costs we anticipated in the non-GAAP guidance. So Table 7 of the press release gives you the breakdown of all these items.

Regionally, our Q1 FY '20 revenue was a split 46% in North America, 22% in Europe, 17% in China, 9% in Japan, and the remainder was in the rest of the world. The regional breakdown for legacy II-VI was not actually materially different from this. The regional growth was strongest, actually, in the rest of Asia, namely Korea and Taiwan, and very good in Japan and North America but down about 20% in China.

The company's overall margin for Q1 was 36.2% and 38.3% on a non-GAAP basis. The non-GAAP gross margin excludes the partial inventory ship up -- inventory step up in the quarter of $7.3 million. The GAAP operating margin was negative 5.4%, including all the deal costs and 15% on a non-GAAP basis, down 30 basis points from the same period last year.

Regarding the segment adjusted operating margins for the quarter. Compound Semiconductor was 17.6%, a good advancement of 210 basis points sequentially and 310 basis points compared to the same period last year. Photonics was 12.6%, down 330 basis points sequentially, largely due to mix and being out of capacity on key products.

Our year-end backlog was $720 million, consisting of $386 million in Photonics and $334 million in Compound Semiconductor with about $200 million coming from Finisar. The backlog contains orders that will ship over the next 12 months.

It is worth noting that in our long-term share arrangements with customers for 3D Sensing, bookings are typically recorded during the quarter of shipment. The company had other expenses of $5 million consisting of a $4 million charge for the extinguishment of the former credit facility and $1 million for negative currency. Capital expenditures this quarter were $26 million. For the combined company for the year, we are expecting CapEx in the $220 million range.

With respect to interest expenses of $6.9 million for the quarter, this is related largely to II-VI's previously existing debt. The new debt, interest and mandatory prepayments, they will run about $40 million to $44 million a quarter, $26 million to $27 million of which is interest and 14% to 17% which is mandatory principal repayments. The total expected debt service payments for fiscal year '20, which includes interest and principal, are estimated to be $118 million.

Our cash is $440 million and our net debt position is $2.05 billion. Our total debt ratio is 4.6x and the net debt leverage ratio, the basis of the credit facility, is 3.8x. We are still assessing the tax position of both companies and believe that at this time, the tax rate will range from 11% to 14% for the fiscal year 2020.

Of the $2.9 billion purchase price for Finisar, $752 million was allocated to amortizing intangible assets, $760 million to goodwill and the balance to the tangible net assets we acquired or total assets less the liabilities assumed. Based on our work today, the intangibles will be expensed over a weighted average life of approximately 7 years. Because we have a year to finalize the purchase accounting, these numbers and the weighted average time period are subject to modification.

Regarding our progress on synergies, we're tracking well against our target of $150 million in annual cost synergies within 3 years after the close of the transaction. We have action synergies equivalent to about 20% of our target so far this year.

For the largest part of the COGS synergies, that being supply chain, we established a global procurement organization that includes procurement, materials management and supplier quality. The Chief Procurement Officer directed that this work begin in a clear room prior to the close to define the combined spend for direct materials, indirect goods, services and CapEx; to define our supplier base, including the suppliers we buy from jointly; and to help us identify our sourcing priorities as well as to validate our savings roadmap.

We are aggressively taking action to maximize working capital improvement, including standardizing payment terms for common suppliers and defining opportunities to streamline the number of those suppliers. We don't expect the synergies to generate a significant amount of cash this year because we are planning to action a good portion of the synergies this year and that will have costs to achieve them. Remember that the synergy work is aimed at reducing the total cost plan of both companies combined over the next 3 years, thus improving both the gross and operating margins.

Turning to the outlook. During Q2 fiscal year 2020, a number of activities are underway with respect to integration and qualification, some of which could affect these results. At this point, the outlook for the second fiscal quarter ending December 31, 2019, is revenue of $590 million to $630 million and the EPS on a non-GAAP basis of $0.20 to $0.50. The non-GAAP EPS is adjusted for $18 million in stock comp, $34 million in amortization, $79 million in the rest of the more or less one-time inventory step up and $18 million in costs to facilitate the integration, including the move from Allen to Sherman. The share count to be used is 95.5 million shares. The interest expense, as I noted, is about $26 million. This is at today's exchange rates. We are attending several investor conference in December, and we will provide any updates that we can during those sessions. The pro forma financial statements required to be filed under a Form 10-K/A are expected to be issued on or about December 9, 2019.

Now as we turn to the Q&A for this call, remember that our actual results may differ from these forecasts due to a variety of factors including, but not limited to changes in the product mix, customer orders, competition, changes in the trade and tariff regulations and general economic conditions.

I'll also remind you that our answers to your questions today may contain certain forward-looking statements and for which, results may vary as they are based on our best knowledge today.

Paul, you may open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question will come from Meta Marshall of Morgan Stanley.

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

Maybe just starting with kind of looking forward into Q1 and just -- it sounds -- perhaps some of the weakness to expectations is coming from lower ramps on some of the Finisar products, but just any help kind of between legacy II-VI, legacy Finisar just looking into Q1.

And then second question, just -- Compound Semiconductors had a tremendous amount of operating leverage in Q1. Just anything -- any help there as to where you were seeing that leverage would be helpful.

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

I'll answer the first question -- the second question for you and then Chuck and Giovanni can answer the first part of your question. So as you know, the 3D Sensing business for both companies is one of the few businesses, because of the consumer aspect, where a lot of the capacity, if not almost all of it, needs to go in for qualification. As a result, volume, if it lags, can cause a dis-leverage but when it is shipping, is very, very good. And you -- we see this as well even in Photonics where when the volumes are high, the operating leverage is very good. So that's not atypical in a capital-intensive company. But I would say that particularly in Compound Semiconductor, because of the shipments in 3D Sensing and while down, not dramatically down, just 10%, not what some others are reporting with respect to industrial that also helps the margin mix a little bit.

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

I would add that just to repeat maybe what I said, where actually the call -- we're hosting the call today from Warren, New Jersey from our 3D Sensing and Compound Semiconductor fab. I said it's going extremely well here. The team here have done really a fantastic job and it's really exciting to see. So I think that's -- we've said all along, when we get these fabs drilled to the target utilization, that we would be able to have a real nice business and that's what we're seeing.

For the rest of your question with regard to the business. I think we tried to give a very clear, transparent and balanced view. Each one of our markets in Q1, whether we talk about our traditional silicon carbide or our industrial laser markets, we experienced softness in the legacy II-VI markets in the first quarter. And with regard to the legacy Finisar business, the Web 2.0 scale purchases of transceivers were less than what we expected they would be in the first quarter. And so I would say, it's a mix of both legacy and Finisar business that were a little bit softer than what we would have hoped for or expected, Meta.

Operator

Your next question will come from Jim Ricchiuti from Needham & Company.

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

Chuck or Mary Jane, I think you mentioned that there were some areas that you're experiencing very tight capacity, where you may even be out of capacity. Can you talk a little bit about where that is? Is that in the power amplifier business?

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

So I would say, probably in a few places, yes. So one of the areas is in for optimal communications. We have seen what seems to be the beginning of 5G starting to pick up here and why are we usually see, in fact, even in great years, we usually see the Q1 quarter lower than the Q4 quarter. We are out of capacity on several of the key products, especially comps.

With respect to silicon carbide, we are, as we've talked many times, continuing to increase that capacity and in particular, in this quarter, saw a rise, as Giovanni mentioned, in demand for the semi-insulating substrates, which is used for RF. That caused that conversion of some furnaces and we are -- and constrained the capacity in the first quarter. So we're now on with that. And there are probably a few other places here or there, but those are probably the 2 main ones. What you say, Chuck?

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

Yes. Just recapping for legacy II-VI 980 pumps, semi-insulating silicon carbide substrates and on the legacy Finisar side, we are working aggressively to add capacity in our coherent optics and coherent transceiver manufacturing lines to keep pace with the anticipated demands.

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

And Chuck, just with respect to Sherman, you talked about some of the technical issues. I don't know if you could elaborate on that or not, but you seem to suggest that you see that being resolved in the March quarter. Is that -- should we think about that as occurring late in the March quarter? Or any additional color you can provide on that?

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

There's a chance that could go earlier than the end of the March quarter. There's a chance it could take a little bit longer. With these things, I can elaborate on it this way simply. This is normal to our semiconductor laser fab. These are issues that as soon as you resolve 5 or 10 issues, the next 1 or 2 pop up in your scene. This is all normal. We've been through this in our history. We take it with our heads up. I can tell you this. If there's any way for it to be a day earlier, I guarantee anybody that we'll make it happen if it's possible. And it is a top priority for us and at the moment, I think we'll, suffice it to say, as soon as we possibly can, and we're doing it collaboratively with a great customer. As soon as we can, we'll get on to it.

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

But as far as guidance goes, it's -- you're baking in later in the quarter?

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

In the March quarter, Jim. That's all I'd like to say.

Operator

Your next question will come from Fahad Najam of Cowen.

Fahad Najam - *Cowen and Company, LLC, Research Division - Associate*

I'll start off with a few questions at first. Can you help us understand with the SAMR approval process requiring you to separate the lease. So like, it's business of Finisar for a piece of 3 years. Are you still reiterating your cost synergy targets of $150 million. Can you help us...

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

Hang on a minute. Fahad, hang on a minute. So your question was, can we explain the ruling to hold the WSS separate?

Fahad Najam - *Cowen and Company, LLC, Research Division - Associate*

No. My question is more what is the impact on your cost synergy targets? You seem to have reiterated your $150 million cost savings targets. Is that, I would assume, keeping the laser light switch business separate for a period of 3 years would have impacted that. So can help us understand how much of a put and take it's impacting your synergies target?

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

Okay. Fahad, it's very, very difficult to hear what you're saying or to understand. If there's any way for you to either get -- switch your headset or whatever your system you're on, please make an adjustment.

But I'm going to answer the question that I think I could hear. We started this process with a 150 millimeter -- $150 million of synergies that we have in our plan. We built our objective based on delivering more than that because not everything will hit, not everything will hit exactly on schedule. And we know that we have to run faster just to be able to get to where we want to be and we like to be able to deliver more. That's just our overall culture. That's our attitude. That's the whole place. So for sure, we will have to deal with additional costs that were not in our plan as a result of holding these businesses separate. And we don't know exactly what they are, but we have an estimate of what they are. And that estimate is going to, over 3 years, cause us to run even faster so that we can still deliver on the promise of the synergies. We're not -- there's no mulligans here, there isn't anything. We have to deliver. So whatever we have to take on, we'll take it on. We're going to try to mitigate it all the time because we're so focused on the cost, but we have to do things right. We have to do the right things and we have to go fast. And I'm not at all discouraged about the possibility that there'll be some extra costs. We know that. We're going to have to figure out on how to get some extra revenue or reduce the cost someplace else and we're working on it. Okay?

Fahad Najam - *Cowen and Company, LLC, Research Division - Associate*

Okay. Can you guys hear me now better? Is this better?

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

Yes. Did you hear what I said, Fahad?

Fahad Najam - *Cowen and Company, LLC, Research Division - Associate*

Yes, I did. If you could quantify what the additional head cost from this keeping the laser light switch business, that will be helpful.

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

We're not going to do that on this call, Fahad.

Fahad Najam - *Cowen and Company, LLC, Research Division - Associate*

Okay. If you can also provide us an update on Finisar. I mean, it's been -- your Finisar has been quite beautiful 3 quarters. Can help us update on employee retention, key talent retention especially as it relates to the 3D Sensing. We often hear about people leaving. Can you just give us an update on the employee retention rates?

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

Yes. I would say this. It's one heck of an exciting place to work at and we have a normal attrition rate that we've experienced in running these businesses and I can tell you that I know of no corner of the company where the attrition rate is higher than normal. It's probably lower than normal. There's a lot of people that want to come to work here. And I would say that there's a great interest in people wanting to come to work in such an exciting company where this roadmap -- nothing is perfect but we're determined to be able to match the right talent that we need to have in the jobs that we need to have as part of our day 1 assessment going forward, we've identified a few critical spots of our own assessment and in conjunction with the assessment of some of our customers and we will go and work to fill those. It's at the top objective of us just to retain the top talent that we have and to attract additional people to be able to fuel the growth at this company. I am very, very excited about our engagement with our employees worldwide, Fahad.

Fahad Najam - *Cowen and Company, LLC, Research Division - Associate*

Super. If I could ask a question...

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

We probably need to let someone else have a chance, but if we have time, for sure. We'll be pleased to take any other questions from you.

Fahad Najam - *Cowen and Company, LLC, Research Division - Associate*

Alright. This is going to be a short question. On the industrial revenue, if you can just help us, what was the amount of revenue that was -- the disappointment was due to organic and demand versus you being short in components?

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

For industrial, your question was how much was organic. All of it.

Fahad Najam - *Cowen and Company, LLC, Research Division - Associate*

No. What I meant to say -- sorry, what I meant to ask was, how much of the weakness in the industrial revenue was as a result of the you being out of components and shortening of supplies?

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

On industrial revenue, I think we answered that question. There is a reduction in new systems built and as the GDP in some major industrial countries declines, that has an effect on the aftermarket. So operator, let's take the next analyst on the call.

Operator

The next question will come from Samik Chatterjee of JPMorgan.

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

So just wanted to see if you can dig a bit deeper into a couple of end markets, particularly in optical communications, telecom and Datacom. You mentioned this trend you're seeing in telecom related to 5G. So just want to understand if it's across all geographies or if -- are you seeing a weakness in China? And then on Datacom, is there any visibility at this point in terms of a stabilization in that end market? Or what your plans would be able to be on Finisar business there in terms of you're seeing some competitors switching from [modules] out to chips. So any thoughts there?

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

I would say our telecom business, our optical communications business is a strong and I mean, a real driver is to turn on in 5G. I mean, our factories around the world are working feverishly to keep pace with increases in orders and increases in demand associated with 5G. So that's a key highlight. That's in China. I would say that's across all geographies. It's just been strong. Every geography we report, China, U.S., North America, Japan and then the rest of the world, too. So that's a real driver. I think that's going to continue.

On the Datacom side, our best view is that the market probably will go through another 2 quarters, maybe. And so our model today anticipates that in the second half of the calendar year, we'll begin to see the lift in the Datacom business.

In the meanwhile, I said earlier, our coherent optics and coherent transceiver business is experiencing a tremendous amount of interest, as is the interest in the indium phosphide base laser component sales. We've had a number of seminars with customers already around the world and there's a great deal of excitement. People are already beginning to dedicate design and qualification resources to be able to get our lasers fit in both form, fit and function into their products. And that element of our strategy seems to be right at the -- on day 1, an enthusiasm that people have been waiting for.

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

Got it. Mary Jane, a quick follow-up, if I may. You're reiterating a lot of your synergy targets and I understand the headwinds here are from the macro perspective. Are you also reiterating the 10% EPS accretion in the first full year? Or is that something you have to kind of see based on how you deliver on synergies through the year?

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

Right. I think your latter part of your question probably answered it for yourself. I mean, I think we've seen some changes as Chuck summarized at the end of his remarks in at least 2 of the major end markets, if not really 3, that are causing the ramps -- for the ramps for 3D Sensing, for example, to be lower than we would have anticipated.

Having said that, obviously, that would have been affecting the II-VI base business as well, changes in the end markets. You can see that from the organic growth in the quarter.

So as a result of that, I think what I'd like to really do is take the time to be through, not only the pro forma that was -- is due in about a month's time here, but also to, as Chuck put it, have at least 1 full month of looking at how the company is doing and what we can to to support the accelerated growth we're seeing in some cases on the top line, but also and how we can work more efficiently together to able to see how we think we'll end the year. So I think that's really the best way to think about it, exactly as you already have, Samik.

Operator

The next question will come from Simon Leopold of Raymond James.

Simon Matthew Leopold - *Raymond James & Associates, Inc., Research Division - Research Analyst*

I wanted to see if we could dig a little bit more deeply on the trends you're seeing in the -- what used to be Finisar's transreceiver business. I think Giovanni indicated he expected improvement in the second half of '20. Just want to make sure that's calendar fiscal, but understand, what's driving that? Is that about new products or is this something that you see within the demand side? I'd like to get a better understanding of the trajectory of that particular business.

Giovanni Barbarossa - *II-VI Incorporated - President of Compound Semiconductors & Chief Strategy Officer*

This is quite a busy pipeline of new design wins that the team expects and we think that whether it's 100, whether it's 400, whether it's 800, as I said, all of these bandwidth capacities will require new gears and so without going over through the customer list, obviously, we can't. We see that as an opportunity of the business to bounce back a little bit on where it is today. So we're very, very confident that the strength of the team is there, the vertical integration helps a lot. Some of the internally sourced coherent solutions that Chuck mentioned are very competitive. So it's an array of activities going on that we narrated and they are very, very promising from our standpoint. That's why we made a comment.

Simon Matthew Leopold - *Raymond James & Associates, Inc., Research Division - Research Analyst*

And maybe just to drill down on 1 particular area. A number of OEMs have talked about vertically integrating silicon photonics and you've got some other players with silicon photonics. I don't know that we've heard much from Finisar for about a year on this topic, so it's been quiet. Just how do you compete against those kinds of products? Will you have your own? Or are your costs better? How do we think about that?

Giovanni Barbarossa - *II-VI Incorporated - President of Compound Semiconductors & Chief Strategy Officer*

Okay, thanks, Simon. Yes. So we have some activities here on Photonics. It's one of the many platforms that the team has been working on over the past few years. Obviously, at the same time, I have to say, it's hard to believe that silicon photonics will replace indium phosphide for many applications. And so in some applications, I think there is an advantage, even if as you probably know in some demanding applications, silicon photonics has to be complemented by an amplifier, which creates a great opportunity for our amplifier team to be designed in.

In some application, maybe you don't need an amplifier and that's something we are working on as a team in II-VI. So again, it's one of the many platforms that we have available to us. We have a number of partners that we working with to deliver the high chips for the right applications, and they complement well with the rest of the indium phosphide as well as the IC platforms that the team has developed over the years.

So just -- I think there is some activity going on but it's just one of many. We are not working on silicon photonics to make our products more attractive. It's just one of many platforms that you need to have at your disposal to deliver the best power money can buy. And that's -- I was Chief Technology agnostic officer and I believe that, that's still the case. It doesn't matter what the technology is. I know that's all you have. You would only talk about silicon photonics. If you don't have only that, you also talk about silicon photonics. I think that has been Finisar and the II-VI attitude towards that specific platform.

Operator

(Operator Instructions) The next question is from Timothy Savageaux.

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

I'll try to keep it somewhat coherent here, no pun intended. If you look at your total revenue guide for fiscal Q2, a couple of questions about that. I guess about $610 million mid-range. A, you've mentioned the strength in telecom pretty consistently. If you look at both what came over from Finisar and the growth on the coherent side as well as your overall telecom business, can you give us a sense of that Q2 guide? How much of that is telecom? And I assume you expect that to grow year-over-year. And I will follow-up.

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

So it's pretty hard for us. We don't normally break this down by end market. I mean, I do think that we would expect to see some of the growth from that area. But I would say the other things, there are some as we just discussed in the call, some downdrafts we're dealing with, whether they be in industrial or as Chuck went into some great detail about the resolving some things from a 3D shipping point of view from Sherman.

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

Got it. Well, the team said it could be like 40%, 45% or so and that's kind of where I was headed. If you look at kind of comparable to last year, it looks like that the comparable guide is down almost 10%, high single digits. And realizing you're going to be wanting to move away from legacy II-VI and Finisar concepts rather quickly, given this is the first quarter out of the box, I wonder if you can characterize that high single-digit or nearly 10% decline? Do you expect to see that across the legacy II-VI and Finisar businesses? Or would that be concentrated in Datacom, in Finisar and maybe industrial at II-VI? Any color there would be appreciated.

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

Okay. Sure. Well, first of all, I'd say the guide's wide, right? There's still a lot to get underneath. But I would say that if you think about the size of the business that's coming in, it would not be unreasonable to think that some of it would be on the Datacom side and if not, really most of it. I would say that as we look at the opportunities before us, it will be -- I think for all of your benefit, important to judge kind of revenue synergies, dis-synergies on a little bit more aggregated basis than 1 quarter. But I think you are on the right track that probably most of it is really still from the Datacom side because as Giovanni said, we have seen that market continue to decline, as I think you guys have well. And it's more of a calendar 2020 recovery Giovanni talked about more than fiscal.

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

Great. And just very quickly, I missed the Photonics Compound and Semiconductor backlog numbers. If you could repeat that total backlog ex-Finisar. And I have 1 more.

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

Let me start with the ones you're asking. So it's $334 million for compound semi, it's $386 million for Photonics. And then Finisar brought about $200 million of the backlog, which you'd have to assume, right, based on how their business has been structured over the years, that most of that is in Photonics.

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

Got it. And final question. If you look at the Q2 bottom line guide, you're obviously impacted by interest expense. I would gather without any -- too much synergy impact although you did talk about hitting the ground running. So it kind of looks like we're adding up the respective expense run rate. I assume there's some synergy impact in there. I think you mentioned a metric of 20%. I'm not sure if that reflected your expectations for the year or the quarter. But at a high level, how much synergy is contemplated on the expense side either in COGS or OpEx in your bottom line guide for Q2?

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

Right. First of all, as you look at the expenses forward, right -- so this is why Chuck is talking about continuing to look at the synergies. But generally speaking, if you think about kind of how the business model was done, the revenue would have been increasing. And so obviously, the OpEx would have had some movement as well to accommodate the increasing revenue. The first thing that we're trying to do is severely moderate what an increase curve is. But to your question overall, we had originally estimated that in the first year, we'd have about $35 million of synergies. Again, less than say $50 million, $150 million to buy trade because we don't necessarily have it for the whole year.

So I think to try and identify synergies on every single line item after one quarter might be pretty hard. I mean, from an executive suite point of view, those people, yes, are now no longer among us, doing very well elsewhere. But for example, on the audit fee, the audit fee comes in across the year. So it doesn't all materialize in the first quarter. So in terms of actually realizing it, it'll be realized through the year. Some of the ones we're counting has having been actioned and agreed. It doesn't mean they actually hit the second quarter in the full amount. But generally speaking, I would say that we're looking at somewhere of at least in the neighborhood of $30 million to $35 million for the year and as Chuck said, we will be getting on with that very, very quickly given that we've also seen some changes in the top line profile for the company in this year already.

Operator

And that concludes our Q&A session. I would now like to hand the conference back to Ms. Raymond for closing remarks.

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

Thank you very much, all of you, for joining us. We like to -- we'll update you on our results for sure when we report out the second fiscal quarter of fiscal year '20 in early February. And as we indicated, if we have any updates we're sharing, we'll have 4 investor conference after Thanksgiving and we'll be seeing you then.

So thank you very much for joining us, and we'll talk to you soon. Bye-bye.

Operator

Ladies and gentlemen, this does conclude today's teleconference. You may now disconnect your lines, and thank you for your participation.

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