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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the II-VI Incorporated FY '20 Second Quarter Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to turn the conference over to your host, Ms. Mary Jane Raymond, Chief Financial Officer.

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Thank you, Kyle, and good afternoon. I'm Mary Jane Raymond, the Chief Financial Officer here at II-VI Incorporated. Welcome to our second quarter earnings call for fiscal year 2020. With me today on the call from our Silicon Valley regional headquarters in California 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 Monday, February 10, 2020.

Our press release, 10-Q and our updated investor presentations are available on the Investor Relations tab of the website, ii-vi.com.

Just as a reminder, any forward-looking statements we may make today during this teleconference are given in the context of today only. They contain risks and factors that are subject to change, possibly materially. We do not undertake any obligation to update these statements to reflect events subsequent to today, except as required. A list of our risk factors can be found in our Form 10-K, and new risk factors arising in the current period can be found in the quarterly 10-Q.

We will also share some non-GAAP measures. The reconciliations for these measures are typically found at the end of each document that uses them, such as the press release or the investor presentation.

With that, let me turn the call over to Dr. Chuck Mattera. Chuck?

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

Thanks, Mary Jane. Good afternoon, and thank you to everyone for joining us today.

Our second quarter performance was strong on many fronts. This performance is the result of growing customer demand for our products across key end markets and continued success with our M&A integration efforts.

We made it our first priority to seize the right opportunities to deepen customer trust and increase the mind share of our high-value customers who seek strategic partners like II-VI with a track record of delivering market-leading technology in compound semiconductor devices and photonic solutions, those who operate in a global footprint and have the financial stability to deliver innovations over the long term.

As a result of the acquisition, we are seeing customers increasingly leaning on us now that we possess the broadest product portfolio, applications expertise and scalable manufacturing capabilities in the optical communications industry.

Customers realize that our business is built on enabling technology platforms, a broad IP portfolio and experienced people who can take on the toughest challenges and emerge with differentiated products.

Our optical communications end market was very strong. Our growth was driven primarily by 3 factors: increased demand for our transceivers and related components; the continued strength of the ROADM components combined with market share gains; and the overall emergence of 5G.

Our ramp of new products for 5G has accelerated as over 80 carriers rearchitect their networks to handle the transition from 3G and 4G as 5 billion mobile subscribers today begin to migrate to 5G. We believe that a large and multiyear opportunity for II-VI is unfolding.

During the quarter, we saw the Datacom market begin to recover, driving robust performance for transceivers this quarter, beating our revenue expectations by $40 million. The organic growth of Datacom VCSELs was 30% year-over-year and 38% sequentially. These are not only great results, but they validate our components and module strategy. We expect this strategy to also drive indium phosphide laser component revenue by leveraging our existing sales channels and our world-class technology platforms.

ROADM subsystems and components continue to be strong with 16% organic sequential growth. Sales were very strong of amplifiers, line cards and all enabling components, including passive optics, wavelength selective switches, which experienced record demand, and 980-nanometer pumps, which also experienced extremely strong demand for undersea applications. In fact, when accounting for the accelerating demand for 5G, most of these manufacturing lines were sold up.

In addition, the success of our earlier acquisitions are enabling our success in our low-power consumption wavelength selective switches at the edge of the network, where we are seeing a lot of interest and early adoption.

Moreover, advancements in operational excellence has significantly improved margins for these products.

Our silicon carbide business grew 77% sequentially and 14% year-over-year. We are continuing to diversify our customer base and gain long-term contracts in both RF and power electronics. Our capacity expansion is also well on track.

For 3D Sensing, we had record shipments from our fab in Warren, New Jersey. Growth more than doubled both sequentially and year-over-year. The ongoing operational excellence and quality improvement initiatives at Warren have resulted in the manufacture of VCSEL arrays at high volumes with sustained high yields and high reliability. We are bringing all of our experience to bear on the launch of new products at Warren and to position Sherman as a world-class compound semiconductor device fab. They are well on their way, and I'm excited about the work we are doing to qualify our VCSEL manufacturing line at Sherman.

Our target remains to complete the qualification inside this quarter and I am optimistic about it given the progress we've made. We believe that the sustained investment to establish an in-house vertically integrated 6-inch platform will enable us to achieve the most competitive and long-term viable cost structure in the industry for manufacturing advanced compound semiconductor devices at scale.

In Aerospace and Defense, our businesses continue to grow nicely as we signed some large contracts during the last quarter. Aerospace and Defense is increasingly turning into a new growth market for II-VI with 13% sequential growth this quarter.

Our advanced materials, electrooptic components and subsystems platforms combined with the semiconductor laser are central to our growth strategy in this end market as we align our capabilities with our high-value customers to enable them to win.

We have 4 major market segments of the market that we are allocating our capital to and to complement the capabilities of our most recent acquisitions. Those 4 segments are: F-35; satellites in contested space; hypersonics; and directed energy.

Our integration is off to an excellent start. The cost reductions anticipated are a major priority for us. We need to align our cost with market realities and deliver not only synergies but improved long-term operating performance.

Our new values underscore our commitment to drive efficient allocation of capital, improve cash flow and sustained long-term returns. Our sales and global procurement organizations accelerated quickly and they're delivering synergies right on track. Our segment and corporate leaders have led by example, and all have contributed to creating the tone and tempo at the top around delivering the cost synergies and operating performance achieved to date.

Finally, I'll spend a minute on the evolving coronavirus outbreak. First, we are committed to protecting the health and safety of all of our employees while delivering for our customers.

I am proud of our worldwide leaders who have collaborated from the offset to provide a business continuity and emergency management plan and who are carefully tending to the needs of our employees.

We have been in daily communications with our China-based employees and the local governments where we operate to be sure we are fully knowledgeable of the changing landscape and fully compliant with the requirements.

Beginning today, about 1/3 of our China workforce returned to work. Our operating model for the quarter contemplates that they will all be back to work within the next several weeks.

As we reported in today's press release, our financial outlook for the current March quarter is expected to be affected and has been reflected in our guidance. Mary Jane will provide some additional color on this later as it relates to the short-term impact.

Regarding business continuity planning, I would like to remind everyone that we are -- also have a major manufacturing footprint in Asia outside China. So we are working closely with our strategic customers to shift some demand to our factories in Malaysia and in Vietnam to mitigate any impact to their supply lines.

Before I turn it over to Giovanni, I'd like to thank our customers, our business partners and our employees for enthusiastically aligning around our strategy as we work to position II-VI for the tremendous growth opportunities ahead of us, and in particular, I wish all of our China employees good health while we thank them in advance for their hard work as they return. Giovanni?

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

Thank you, Chuck, and good afternoon. The multiple market drivers of our growth this quarter and is called enduring logic of our strategy, which relies on engineered materials, differentiated components and operational excellence to provide our customers vertical integrated solutions with high barriers to entry.

Prior to the acquisition, II-VI established a strong business in components for Datacom transceivers, which represents today 13% of our organic pre-Finisar communications business. The introduction to the merchant market of previously captive Finisar components seems to be well timed since we just saw our organic business pick up 20% sequentially and 24% year-over-year. In fact, within a few months of closing the acquisition, we are already in the process of multiple qualification engagements for indium phosphide-based components.

Additionally, to support the anticipated market growth, we just announced an industry-first 6-inch wafer manufacturing platform for Datacom VCSELs. We are continuing to invest in product and technology differentiation in lasers, including DMLs and EMLs, to get ready for what we believe will be a strong uptick in the Datacom market in the second half of calendar year 2020.

The 100G transceiver business, currently the largest part of the total addressable market, was very strong in the quarter and ahead of expectations. Our growth in 100G was driven by hyperscale data centers, which continue to upgrade the leaf-to-spine interconnections from 40 to 100G. Strong feedback from our major customers is an indication of continued momentum in this market.

Regarding 200, 400 and 800G Datacom transceivers, we're currently the market leader in 200G. We've been shipping 400G products for some time with several other design-in qualifications underway. And we also have 800G modules in design. We particularly expect that for 400 and 800G, our leaderships in lasers, optics, and integrated circuit design expertise will be vital. This is because we believe that the multidisciplinary excellence in lasers, optics and electronics is especially critical to accelerate our time to market and to deliver the best-performing transceivers, modules and components money can buy.

It's clear from recent actions by competitors that the merits of multidisciplinary competence within the same company is a winning strategy to continue to lead in a very competitive market.

We have significantly increased our investments in coherent optics, especially in R&D, and are pleased with the progress in transmitters and receivers, including tunable subassemblies as well as in transceiver modules. We have recently secured 8 design wins. We have started shipping production volumes, and we have 13 design-in qualifications underway. Coherent optics now represents about 15% of our transceiver business.

In silicon carbide, we are in the process of expanding the physical footprint of our manufacturing infrastructure and additional capacities coming online according to schedule. The growth this quarter was largely in RF, a trend that started in the June quarter. While demand for power applications like electric vehicles is down year-over-year, we saw a nice pickup sequentially, doubling since last quarter.

Industrial was flat sequentially, though it is still below the prior year. We saw the beginning of a recovery sequentially in Asia overall, including China, likely indicating the resumption of laser utilization.

Components for semiconductor capital equipment were in high demand, continuing the strength we reported last quarter driven by the global logic semiconductor market.

Our EUV business, which was flat year-over-year and grew about 7% sequentially, is now experiencing a resumption in growing demand. And we expect this to continue over the next 12 months.

Aerospace and Defense is really taking off. We had growth in both new and existing programs and have a very healthy pipeline of new design-in opportunities where we have a significant ability to differentiate the end solution.

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

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Thank you, Giovanni, and good afternoon. First, to summarize all the growth and distribution by end market.

The company's reported revenue growth was nearly 100% year-over-year since Finisar was not in last year's results. The better total company measure to use is pro forma, including Finisar's results from similar prior periods using Note 3 of the 10-Q.

Apples-to-apples, the company's -- the total company's year-over-year growth was flat. Organically, pre-Finisar, year-over-year growth was 5%. Year-over-year, the communications reported revenue growth is 200%, same reason Finisar wasn't in last year. But on an estimated pro forma basis, growth year-over-year in communications was down 4%. Organically, year-over-year, communications grew 2%. As for the other end markets on a reported and organic basis, consumer doubled year-over-year. Aerospace and defense grew 20%, components to semiconductor capital equipment grew 6%, and industrials declined 12%.

Sequentially, on a proforma basis, the total company grew 10% and communications grew an estimated 4%. For the other end markets, consumer doubled sequentially as well. Aerospace and Defense grew 13%. And finally, industrial and semiconductor capital equipment were flat.

During the quarter, the total revenue of $666 million was split 70% in communications, 11% in industrial, 7% in aerospace and defense, 5% in consumer, 4% in semiconductor capital equipment, and the rest is in the other end markets. Geographically, our end market profile continues to be well diversified with 39% in North America, 19% in Europe, 14% in [each of] China and the rest of Asia, 8% in Japan and 6% in the rest of the world.

The non-GAAP gross margin was 35%, mostly due to the elimination of the $81 million onetime expense from the step-up of the acquired inventory. Operating margin on a non-GAAP basis was 9.8%, including the start-up costs for Sherman, which were $19 million in the quarter. Sherman costs, added back, would yield an operating margin of 12.6%, so we are looking forward to putting those costs to work.

Non-GAAP EPS was $0.36 with the pretax non-GAAP adjustments of $144 million coming in very close to our estimated $149 million, though our tax attributes are now such that we need to tax-effect these items. Non-GAAP return on sales was 5%.

At the segment level, the adjusted operating margins were 12% for Photonics and 5% for Compound Semiconductors. Photonics benefited from the pickup in the transceiver volume and richer mix, including more than doubling its submarine pump sales. Compound Semi also benefited from strong VCSEL arrays organically. Their results include the $19 million of start-up costs for Sherman, which account for 9 points of the segment operating margin.

Our quarter-end backlog was $681 million, consisting of $333 million in Photonics and $346 million in Compound Semiconductors. This compares to last quarter of $721 million total, with $386 million in Photonics and $335 million in Compound Semiconductors. The backlog contains orders that will ship over the next 12 months.

Capital expenditures this quarter were $55 million. For the combined company for the year, we are expecting CapEx in the $150 million to $200 million range. Interest expense was $28 million for the quarter. Debt decreased $80 million with repayments during the quarter on the revolver and the term loans. The total expected debt service payments for the quarter are $30 million in interest and $17 million in required prepayments. Our cash is $376 million and our net debt position is $1.92 billion. Our net debt leverage ratio on the basis of our credit facility is 3.8x.

We are still assessing the tax position of the company but believe at this time that the tax rate will range from 9% to 12% for fiscal year 2020. Regarding our progress on synergies, we are tracking well against our target of $150 million in annual cost synergies within 3 years of the close of the transaction. At this point, we have identified all of the target synergies. Along with these cost reductions, we have also turned up our efforts on working capital improvements, including standardizing payment terms for common customers and suppliers and defining opportunities to streamline purchased services.

Regarding the trade agreement in December, that was a welcome change to the heightened tensions, and we hope that discussions progress favorably from there. With regard to restrictions on specific customers, further actions have been stayed at this time. We continue to serve all customers within the bounds of the allowable trade compliance guidelines.

Turning to the outlook. Consideration of the coronavirus effects are included in our guidance. The effects are potentially broad-reaching. Not only are many of our factories and employees dealing with a longer Chinese New Year holiday, there are also potential effects on the overall supply chain. We expect to be moving back to full strength over the next several weeks. We have, therefore, included a minimum of $50 million revenue reduction in our guidance to account for these conditions.

Guidance then for the third fiscal quarter ending March 31, 2020, is revenue of $550 million to $600 million, and the EPS on a non-GAAP basis is $0.02 to $0.32. This is at today's exchange rate and at an estimated 10% tax rate.

The non-GAAP items in the EPS total $0.59, including the pretax amounts of $16 million in stock compensation, $34 million in amortization and $13 million in costs to facilitate the integration. The share count to be used is 94 million shares. The tax rate and exchange rates are subject to change.

We were pleased to see some of you at Photonics West, and our investor meeting at OFC will be Tuesday, March 10, at 4:15 Pacific Time.

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 product mix, customer orders, competition, changes in trade and tariff regulations, employee health issues and general economic conditions.

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

Kyle, you may open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Meta Marshall from Morgan Stanley.

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

Maybe 2 questions for me. On the Datacom transceiver side of the business, that seemed exceptionally strong. Can you just give a sense of whether you thought that those were market share gains or just kind of stronger demand in general? And was it a change in generation of speed that kind of drove that? And then maybe second, just on the coronavirus impact. Is, how you evaluated that, kind of, production ability or demand currently? Just any helpful as to whether that number was triangulated on supply or demand.

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

Meta, this is Chuck. Thanks for your question. On the Datacom side of the business, we think it's the demand. And we are positioning ourselves for market share gains. But we think this time around, it was demand.

On the coronavirus, I want to tell you that our order book for the third quarter as we closed 12/31 was extremely strong. And our care and carefulness here is just simply measured by our ability to get people back and to fully assess any holes that we may have in the supply chain. And I can guarantee that we'll do everything we can with what we have, but we are not limited by orders. And based on the enthusiasm that we feel, I think that if we could ship everything we'd be able to take on even more business that we have scheduled for the fourth quarter.

Operator

Your next question comes from the line of Jim Ricchiuti from Needham & Company.

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

So looking at that shortfall that you're anticipating as a result of coronavirus, is that $50 million, should we think about it again mainly in that 70% bucket that's optical communications? Are you seeing some impact in industrial? It sounds like it's more in the 70% portion of the business.

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

It is. We have some products from Com Semi that are processed in China. But generally speaking, I would say that it's very, very likely that you've got it exactly right.

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

Now if you -- as you look at the supply chain, obviously, that's harder to, I guess, identify where there could be some issues that surface as a result of this. What are you seeing so far out there in the supply chain? Or is it too early to tell where some of the issues may pop up?

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

I would say that given our full stream inventory, which we pay close attention to it all the time, but especially at this time, to be able to maximize our revenue and maximize our shipments to our customers. So we'll turn there immediately to both the raw materials, the WIP and the finished goods.

Having said that, one of the great things that we observed here is that even throughout the Chinese New Year and especially afterwards, our teams -- our international procurement teams have been working from home. They have a pretty good view of it. What we simply don't have a good view of yet is how to align the overall shipments that we're going to need to make with the people that we have and how we're going to prioritize. And we're going to do that in close collaboration with our customer. I would say that we have a real good command of the supply chain about that. And a little bit less than 50% of our total supply chain is inside China, and we've done that in part to balance and mitigate the risks. So I think we have a good grip on it, Jim, as best as we can.

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

Got it. And last question for me. Mary Jane, you, I guess, reiterated the cost savings at $150 million. Are you guys still on target, just given the headwinds from the coronavirus to that $35 million in year 1?

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Yes. In fact, I wouldn't be surprised if we didn't exceed it, but we are well on it. Yes.

Operator

Your next question comes from the line of Troy Jensen from Piper Sandler.

Troy Donavon Jensen ***Piper Sandler & Co., Research Division - MD and Senior Research Analyst***

First of all, congrats on the revenue upside here. Nice job.

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Thanks.

Troy Donavon Jensen ***Piper Sandler & Co., Research Division - MD and Senior Research Analyst***

Hey, so Chuck, I heard you -- I think I heard you say 1/3 of the employees have returned to work in China. And Mary Jane, did you say that you expect to be at full capacity within a couple of weeks?

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Yes. We believe that certainly -- probably by at least -- at the latest mid-March is what we're thinking right now. And we expect the increase in the strength in the plant to come -- to increase each week.

Troy Donavon Jensen ***Piper Sandler & Co., Research Division - MD and Senior Research Analyst***

Right. Okay, makes sense. How about just, Mary Jane, for you. Could you give us any kind of help sequentially on where you think gross margins go or OpEx? I'm assuming that has a decline on an absolute basis given the synergies you're talking about, but any help would be great.

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

So again, keep in mind that what we're looking at here is the achievement of synergies on an annualized basis. From a gross margin point of view, that is very tough to call. It really does depend on what the shipments are with respect to the coronavirus. So I would say that in setting the guidance, we assumed a little bit of a heavier fall-through onto the EPS simply because we could have everybody dressed up for the party and not able to ship for not having enough people in the factory.

But the gross margin is an important priority for us. And I would say that I would expect to see a steady contribution to the synergy -- to the OpEx as we go forward. But as for actually giving specific numbers on that, I don't -- we typically don't give one item guidance, but we will also talk more about this at OFC.

Generally speaking, I would say though, that it has been a priority for us to both drive the synergies and preserve the cash, one of which -- both of which together is leading to quite a very, very tight restriction on head count additions.

Operator

Your next question comes from the line of Samik Chatterjee from JPMorgan.

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

Chuck, I just wanted to see if you can give me a bit of background on what the qualification process for the Sherman plant involved. Is this qualification with a particular customer or to certain independent metrics? And how does the qualification place you in terms of business win with customers that you've qualified a plant with?

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

We have basically 2 levels of qualification all the time. One is our own manufacturing line qualification that involves every aspect of manufacturing equipment, materials, processes, our overall process characterization and control, and then in conjunction with our customers in certain cases. This qualification plan is consistent with both. And so we have a track record of qualifying exactly what it is that we need to do, and we are working through it.

And Giovanni, would you like to say something else about our overall qualification? Giovanni's segment is really doing a great job.

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

Yes. Samik, this is Giovanni here. So of course, we have also Datacom VCSELs line there. So it's another platform that we're bringing up to speed after the shutdown of the Allen facility, and that's also part of the overall qualification of the plant. I think we are really on top of the challenges there. And as Chuck said, we believe that we'll be qualified by the end of this quarter -- by the end of March.

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

Okay. If I can just follow up, you mentioned that you're seeing kind of sequential improvement in the industrial market, although on a year-over-year basis might be still declining. How are you thinking about the remainder of the year from here on? And does the coronavirus impact have the kind of -- can derail the recovery in that end market?

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Well, first of all, let me just orient into how we tend to look at this from a growth and/or decline. Normally, when demand goes down for new machines, we sometimes see the aftermarket go up. And as you will remember, the aftermarket is about half of our industrial business. And so what we said in the last quarter was that with the falling GDPs, we had seen lower industrial production driving lower laser utilization.

What it looks to us like we're seeing now and the sequential pickup we've seen is kind of a return of laser utilization. And so that may well continue for a while. That would be nice to see that pick up even more. But we are not making any predictions on when -- and Chuck may have some thoughts to share here, when we will expect to see on the larger industrial market sales of new machines.

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

I would just add, Samik, our June quarter tends to be among our strongest. So in the second half of this fiscal year, assuming the effects of the coronavirus are behind us and the supply chains are back up and running, we would be optimistic about the June quarter.

The March quarter is a little bit harder to call given the situation. And also, we have been following them that I've been talking about here for some time. The Caixin PMI index in China, we think, is a fairly good manufacturing index, is a fairly good proxy for us. And the Chinese government -- and also on February 7, they will not publish the January results until March when they publish January and February all at once.

So we're expecting there's going to be some impact there, even though most of the impact that we have in the $50 million factored in is from communications.

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***

My question is kind of on the pro forma -- refocused on pro forma growth. And I went through a number of metrics there. But I guess just X-ing out the impact of the coronavirus in your fiscal Q3 guide, it looks like on a pro forma basis, you'll still be down. I know something on the order of 3%, 4% year-over-year pro forma. Is that kind of generally accurate? You mentioned flat year-over-year for the current quarter. And I'm just wondering what the kind of puts and takes are. You've made some pretty positive comments about growth in communications, both Datacom and telecom here. So if you look at what's growing and what's shrinking given, kind of address or give us some color on those dynamics. And when you might expect the company to return to a growth footing on a pro forma basis?

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

So first of all, I think what we're trying to indicate for the total company is, in so far as the communications contribution is concerned, that it looks to be turning a corner. That's the first thing.

Second of all, this is the first -- a good quarter again sequentially that we have seen industrial perhaps also starting to turn the corner. Giovanni talked a little bit about in EUV, which after a little bit of a pause, was also turning to great strength. So I don't think that we're going to necessarily predict what quarter that we're going to see growth. But the company as it looks at its backlog, as it looks at its order book and really the excitement of customers, there are a lot of very strong growth factors in front of us. And I think there's no question that we are really beginning to see all aspects of 5G beginning to pick up.

So let me see if Giovanni and Chuck want to add anything.

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

That's great, Mary Jane. Thanks for your question Tim.

Operator

Your next question comes from the line Tim Diffely (sic) [Tom Diffely] from D.A. Davidson. Tim, I'm sorry Tom.

Thomas Robert Diffely ***D.A. Davidson & Co., Research Division - MD & Senior Research Analyst***

(inaudible)

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Tom, I'm not sure there seems to be a little bit of a bad connection on your line. If it would be possible for you possibly to dial back in, when you hit the queue, we'll take your question right away. We'd like to answer it for you, but I really couldn't hear it.

Operator

Your next question comes from the line of Mark Miller from The Benchmark Company.

Mark S. Miller ***The Benchmark Company, LLC, Research Division - Senior Equity Analyst***

Did you disclose bookings or book-to-bill for the quarter?

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

We didn't say what it was, but it's 1.

Mark S. Miller ***The Benchmark Company, LLC, Research Division - Senior Equity Analyst***

Book-to-bill was 1? Okay. You talked about record shipments from Warren in the -- for 3D. I'm just wondering, could you talk a little bit about Android? What are you seeing in Android? Is that also a strong spot for you?

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

Mark, this is Giovanni. No, not yet.

Mark S. Miller ***The Benchmark Company, LLC, Research Division - Senior Equity Analyst***

Okay. And then finally, what were the North American shipments as a percent of total?

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

North America as a percent of total is -- that was standing at...

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

39%.

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

39%.

Mark S. Miller ***The Benchmark Company, LLC, Research Division - Senior Equity Analyst***

And what was Asia, I'm sorry?

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

So Asia, we do in a few parts. So China overall was 14%. Japan was 8%, and the rest of Asia was 14%.

Operator

Your next question comes from the line of Simon Leopold from Raymond James.

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

I wanted to ask 2. The first is just trying to double-click on the coronavirus estimation. I understand that quarters aren't necessarily linear. But rough math, that $50 million delta's roughly 8%, 9% of kind of the midpoint of total revenue. And that's about 1 week. And already, we know that the Chinese New Year holiday was extended 1 week. So it doesn't seem that conservative in terms of a headwind. And I'm just trying to get a better understanding of how you arrived at that $50 million, sort of what you're thinking given that Mary Jane indicated that, sort of, your worst-case scenario suggest workers might not be fully up to speed for what could be more than a month, I think, mid-March. And just trying to understand this.

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Well, first of all, what is -- so the case at II-VI is we had a significant amount of employees work through Chinese New Year. They were registered with the local government. This was allowed. We did that. That's why Chuck says that we have a good handle on the supply chain because we could see the supply chain working during the Chinese New Year period. So that's the first thing.

The second thing is we have, as Chuck said, about 1/3 of our employees back to work. So on the one hand, it's not 100%, on the other hand, it's not 0. So at this point, in our discussions with the leaders of our factories in China, looking at all the factors, looking at what's been produced, looking at January, and how we think the people will gradually come back over the next several weeks, that's how we arrived at the $50 million.

Now do keep in mind, we did say it was at least $50 million. And if the time line were to go on, if there was some other extended set of national directives, yes, that number could change. But basically, that's how we got there.

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

And in terms of the employees you have in China, my rough guesstimate was it's close to 70% of your headcount and that most of the locations, if not all, are considered, I would say, coastal cities. Could you just validate whether or not I've got that right?

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

So first of all, the number of employees, no. It's probably more like 45% of the employees -- 45% to 50%. And second of all, as to whether they're considered coastal cities...

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

80% of the roughly 45% to 50% of our employees are located in our 2 mega facilities, one in Wuxi and one in Fuzhou. None of them are in the Hubei province.

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

That's what I wanted to verify. I appreciate that. And then just on a different topic. In terms of the strength of the WSS ROADM business, it sounds like good demand drivers there. Just wondering if you have any ability to assess how much of that might be related to inventory stocking by Chinese customers. And how much is actually the end market demand? Is there any way to get some insight on that?

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

Simon, it's a great question. We've been asked that for 3 years now, and we answer it every time the same way. We believe that our customers place orders on us for both their end item demand and for the change in their inventory. And we don't have any indication, any agreement or any belief if there's anything outside the ordinary production plus inventory change that's happening in our supply chain.

I do believe that based on our discussions with our customers that not only in the short term, but in the longer term, they would like to see us increase our output of virtually all of these components for 5G and all the ROADM components and not only the ones we make today, but the ones we have in development as well.

Yes, Simon. We're not just -- this is not a 1-quarter game for us. This is a long game. And anyway, I hope we answered your questions, Simon.

Operator

A follow-up question from Tim Diffely (sic) [Tom Diffely] from D.A. Davidson.

Thomas Robert Diffely ***D.A. Davidson & Co., Research Division - MD & Senior Research Analyst***

So Mary Jane, just quickly, I wanted to ask another question on the Sherman start-up costs. So right now, the compound semi margins were down quite a bit sequentially. If you take out the 9 points from the Sherman facility, they're still down 300, 400 basis points sequentially. Just wondering if you could go over the puts and takes there.

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Well, first of all, with respect to last quarter, sequentially, we would not have had Sherman in at all, right? So we only had them in for 22 days. That said -- so that's one aspect of it. The Compound Semi group also includes the 2 indium phosphide fabs, both Jarfalla and Fremont.

And then finally, I would say that while we are probably seeing a little bit of a flattening on industrial -- a little bit of a sequential pickup in industrial, it's -- that's a very rich margin business. I mean those guys are really, really doing a great job, I think, holding their margin, but it's a little bit tough in a downmarket to hold it perfectly. I'd say the same thing is true on EUV, where we're starting to see EUV also start to pick up but after a period of pause. So I think those are probably the factors. As indium phosphide components start to be sold, we would then be able to see positive contribution from those factories into the segment.

Thomas Robert Diffely ***D.A. Davidson & Co., Research Division - MD & Senior Research Analyst***

Okay. So low teens is a good base starting point. And as volumes ramp, you expect to see a nice ramp in the margin as well.

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Yes. Exactly. I think the one thing to keep in mind, too, is when we talk about the start-up costs being added back, at some point, we want to be selling these costs, right? So we also need the margin of those products, which helps us as well on the operating margin.

Thomas Robert Diffely ***D.A. Davidson & Co., Research Division - MD & Senior Research Analyst***

Okay. Good. And then finally, did you disclose the EPS impact of the $50 million revenue hit?

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

We didn't. But the way I would tell you to estimate it is, we took a pretty heavy fall-through on that, probably as much as 50%, because we could find that we're all ready to go and then people can't come to work.

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***

Questions on 3DS. I was wondering if you can break out 3DS revenue. And I believe you said Warren doubled sequentially. Just wondering how did Sherman do on a pro forma basis. And what's the mix between North America versus Android customers?

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

Hey, Dave. As we said, the Sherman facility is not qualified yet. So you need to assume that all revenue for 3D Sensing is coming from the Warren and Easton facility.

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

Got it. Got it. Got it. And then what's the -- from Warren, what's the mix between North America versus Android?

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

But as I told, Mark, we have no Android revenue yet from Warren.

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

Got it. And then on the $50 million impact, are you assuming any kind of supply disruptions for your 3DS?

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

So with respect to at least the -- $50 million of at least on the corona effect, that we would not necessarily expect to have a 3DS effect actually. As you know, all of our laser diodes and growing materials in II-VI with the exception of 2, are actually grown outside of China -- they're grown and made outside of China.

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

But then your [Foxconn] cannot produce now. I guess they're going to be delayed for maybe a few weeks -- a couple more weeks. I mean doesn't that impact your 3DS business?

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

We can't comment on that.

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

Okay. Fair enough. And then just lastly, on silicon carbide, I guess, it was 6% last quarter. Now with Finisar, I assume that number will be down. Is it -- what is it now, like maybe 3%, 4%, 5%?

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

So just kind of look at it. The silicon carbide -- yes, was 3% in the quarter and growing over last quarter, which was about 2%.

Operator

Your next question comes from the line of Jed Dorsheimer from Canaccord Genuity.

Jonathan Edward Dorsheimer ***Canaccord Genuity Corp., Research Division - MD & Analyst***

I guess, first, with respect to the $50 million and sort of the mid-March target for full production. If it were to extend longer, I'm just curious, are there any force majeure clauses, like, in your umbrella policies or insurance policies that we should be aware of that might help to offset? And then I have a follow-up.

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

So, so far, we've looked at our insurance policies. Obviously, we would need to show actually incurred business interruption, financial losses. And if that were to be the case, I'm sure we would find our insurance companies to be cooperative within the bounds of policies we have.

Jonathan Edward Dorsheimer ***Canaccord Genuity Corp., Research Division - MD & Analyst***

Is there a way to gauge potential offset? Or how should we think about that? I mean, I'm sure a virus would constitute something that's act of God, out of your control. So I'm just curious how we should be thinking about that.

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

I think it's -- I don't think there's a way to give you what the insurance offset potentially is. I mean, at this point, while we do think we have a $50 million -- at least a $50 million impact from this, at the end of the day, it is going to be gauged on what is actually happening. So I don't think we can estimate insurance proceeds for you. I think more likely than not, what the company would do is actually try to manage expenses in the meantime.

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

It's a great question, Jed. I -- it is a very good question. And I'm fortunate to have a great team around me who are also asking that kind of a question, just to be sure that we've covered all the bases.

But I want to say that while that's happening in the backdrop as it should, our top priority is to take care of our people, get the factories up and running and to find a way to help our customers not skip a beat. That's our first harbor of appeal, and we're focused on that. Okay?

Jonathan Edward Dorsheimer ***Canaccord Genuity Corp., Research Division - MD & Analyst***

Got it. Understood. And then my follow-up question, just around silicon carbide. Any commentary around capacity expansion? It seems that the industry remains fairly tight, and I'm just curious how you're thinking about capital allocation with respect to that business in particular.

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

Jed, I'll take it. We -- 90 days ago, we said that we secured a new facility to allow us to expand into, should provide us with a significant runway. Has all the right characteristics: close to our people; very low-cost electricity; and will allow us to scale. And we said that 3 to 5x our current capacity inside 3 years and could be faster. And we'll have it subject to the market.

We have 2 initiatives underway. One is to allow that capacity expansion to be as short as possible so that we can respond quickly to one forecasted increases in demand. And the second one is for us to accelerate the pace of the technology improvements that we want to make to get ready for another generation of high-quality, 200-millimeter substrates.

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***

Maybe a question on the Datacom space and I apologize if I missed any detail in the prepared remarks here, but if you can give us a sense of how much of the pickup that you saw was from kind of the mainstream 100-gig modules and components versus 200 and 400? And then, are we expecting any sort of pickup in the fiscal third quarter? And if not, when do you expect to see a bigger pickup from those higher speed, 200 and 400 modules?

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

Hi. This is Giovanni. So as we said in the script, the 100G still represents the largest share of the total addressable market and including, of course, our underserved addressable market. So there was the largest percentage of the growth.

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

Okay. Anyway, do you have -- you can more characterize the overall size there? Is it -- I mean is 400, 200 -- is that 10% or more of the total Datacom business today?

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

I don't -- we don't report numbers by [further] lines, as you know, let alone speeds. I think they are growing, they're growing fast. But the bulk of demand is still on 100G. And I think, as I said, we think we are the leader in 200G. And 400G is coming fast, and we are ready. And as I said, we're also working on 800G concepts and designs to be ready for that as well.

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

Okay. Fair enough. A follow-on question on Aerospace and Defense. Chuck, I think you mentioned you think this is returning to more of a growth market, and you said you signed a few large contracts. I wonder if you could characterize or identify any of those. And in the past, you talked about kind of high-energy lasers as a key area. I'm wondering if that's fitting within the category of the -- of any of the large contracts you signed.

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

Let's see, the -- we will not disclose today the nature of the customer for the large contracts or the application. And I outlined 4 major areas of investment. Directed energy is just beginning, and I believe that our latest 2 acquisitions, in combination with our semiconductor laser technology platform, is positioning us extremely well in the supply chains of the early adopters of directed energy systems and components.

So that's really an exciting growth area at the moment. At the moment, we are making the largest investment we're making in people for our expansion and these invested programs is in the Aerospace and Defense business.

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

Okay. I have a quick follow-on question for Mary Jane. Mary Jane, do you have any start-up costs for the Sherman fab built into your guidance for the current quarter?

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Yes.

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

Can you quantify how much?

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

It's probably in the same range that we're seeing right now in the 19 sort of range.

Operator

Your next question comes from the line of Paul Silverstein from Cowen.

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

I apologize, I was dropped a little bit, so I apologize if this came up earlier. With regard to Sherman, I trust in your commentary, you still need to get qualified some revenue...

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

Hey, Paul. Good afternoon. This is Chuck. I beg your pardon for interrupting you, but we're receiving everything you're saying as a muffle sound. And we know it's you, but we can't really decipher what you're saying.

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Could you just start over, please?

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

With respect to Sherman, I trust from your commentary that it still needs to finalize qualification that you do not have revenue -- or much revenue in the March guidance. The question is, as you look out to June, and I appreciate it's hard enough forecast 90 days out. But as Sherman comes on stream, is it possible for you to say how much incremental revenue or to give a range of the prospective incremental revenue out of that facility above and beyond what you're already doing? That's the first question. The second question is, did you have any 10% customers?

And in connection with that, can you say, even if it wasn't 10%, given all the focus and the concern over the past year or 2 about Huawei, how big was Huawei for the combined company, II-VI plus Finisar, as well as for II-VI proper? And Chuck, I heard your response to a previous question that you're not concerned with respect to inventory buildup by China. I assume that extends specifically to Huawei as well, but I'm wondering if you have any -- if you can share with us the type of insight you have in terms of what your customers are up to, to the extent you can or you're willing?

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

Okay. There was a lot of questions in there, Paul. Thanks for your questions. Number one, on the June quarter for 3D Sensing. We're not going to be able to discuss what we think the likely outcome is for revenue in the fourth quarter.

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Or any quarter.

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

That will really be a subject of commercial discussions. So we can't say that today. What came after that? It was about -- whether or not we had any 10% customers?

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Yes. When the -- the last check that we did, the company did not -- the combined company does not have any 10% customers. Obviously, as revenue finalizes for the year, we'll assess that with the June 30 revenue. But so far, we do not.

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

Huawei?

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

With regard to Huawei -- let me also say that we reported that 14% of our revenues came from sales in China in total as a company. So that's another data point. And regarding our direct sales to Chinese customers, because that was the question I thought I was asked, and the answer I gave was with regard to our direct sales to customers in China. To my knowledge, the order pattern is consistent with the market demands and what I believe we've come to understand is the normal pattern of buying both for production and for inventory. And that's with regard to our sales directly to our customers in China. To what extent any other customers that we have, that's a different story, and it's just harder for us to be able to judge and to make comments on.

We think it's just an ordinary course of our sales are being consumed in China. And my discussion was not about Huawei. It was about all of our customers in China, Paul.

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

Understood. Can I squeeze in one last one? From the face of your commentary and your numbers, it sounds like there's been a meaningful improvement across the board, across most of the board with respect to your products and customer markets. And your commentary is very good. Let me ask you a general question about visibility. It sounds like visibility is better. But -- and again, I appreciate it's hard to forecast. And I know you're not guiding beyond the quarter. But the data points you all are looking at, it sounds like that suggests that the improvement you're seeing is of a more secular, long-tailed nature as opposed to just a quarter or 2? That's the question.

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Well...

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

We have a virus now and that virus is going to interrupt. We think, for us, and quite honestly, for everybody that's that walks along the same path. And it's going to take us a little bit of time to sort that out, Paul. And I think beyond that before that came, I want to reiterate, before that came, our 12/31 order book that we had, had a very strong coverage for the third quarter.

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Yes. I would say, in the analysis that we did in the quarter that we have just reported there, especially on the drivers that were stronger than we maybe anticipated actually in how we set the guidance. The uptick does not seem to be limited to this quarter. But given that a few of them are just starting, let's take an easier one, the resumption of some sequential growth in industrial. We'd like to see it for a couple of quarters to say it's really a trend, but it does not. What we saw, we spent a lot of time on to be sure was not onetime.

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

I was just going to say, presumably, unless coronavirus is the black plague, that is a transitory event and that, too, shall pass. So I recognize your guidance is so but go on, Chuck, I'm sorry.

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

Thanks a lot, Paul. I think we tried to lay out the situation here for the quarter as best as we can with all the information we have in hand today. And now our task is to get back to work and harness all the enthusiasm and power of the people of this company, get them back to work safely and keep it that way. And we have a whole host of customers that are interested in the best that we can do for them, and that's what we're out to do.

Operator

I'm showing no further questions at this time. I would now like to turn the conference back to Mary Jane Raymond, Chief Financial Officer.

Mary Jane Raymond ***II-VI Incorporated - CFO & Treasurer***

Thank you very much, Kyle. This ends our call today. We look forward to seeing you at OFC. And we also look forward to updating you on our results for the third fiscal quarter when we report that in early May. Thank you for joining us. Have a good day.

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

Have a good day.

Operator

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