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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the II-VI Incorporated FY '20 Third Quarter Earnings Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions) I would now like to hand the conference over to your speaker today, Ms. Mary Jane Raymond. Thank you. Please go ahead, ma'am.

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

Thank you, Kathy, and good afternoon. I'm Mary Jane Raymond, the Chief Financial Officer here at II-VI Incorporated. Welcome to our third 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 Semiconductors segment.

This call is being recorded on Monday, May 11, 2020. Our press release, 10-Q and our updated investor presentation 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 risk factors that are subject to change, possibly materially. They contain risk factors -- 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 Form 10-Q.

We will also share some non-GAAP measures in our discussion and materials today. The reconciliations for these measures are found at the end of each document that uses those measures 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***

Thank you, Mary Jane, and good afternoon, everyone.

Before I discuss our quarterly performance, I would like to spend a couple of minutes discussing the extraordinary circumstances that we find ourselves in as a result of the COVID-19 crisis and our response here at II-VI. Let me begin first with a thought for our global health care professionals on the front lines of the pandemic. Health care professionals and emergency responders around the world have faced the unprecedented and unexpected challenges of planning for and addressing the reality of the terrible toll that this disease has brought with professionalism, hard work, care and bravery of theirs. As the contagion spreads in some places and recedes with economic recovery beginning in other places, and as it threatens to reemerge again, governments around the world are doing their best to ease the burdens on their health care infrastructure, their economies, their people and businesses affected by the crisis. These government officials have been and remain in an unenviable position of deciding how to guide us all through these challenging times. On behalf of the II-VI family, I would like to express our sincere thanks, thoughts and prayers to all of the dedicated professionals in emergency health care and government, who are doing their very best to care for, protect and guide us through these challenging times. My thoughts are also with all of you, your families and your communities.

According to Teddy Roosevelt, in any moment of decision, the best thing you can do is the right thing, the next best thing is the wrong thing, and the worst thing is nothing. Here at II-VI, our dedicated worldwide workforce of 22,500 people have been doing things right and doing the right things and demonstrate the advantage that accrues from a II-VI culture of preparation, alignment and speed of execution around the world that underscores the integration progress that we've made. Since the very beginning of this crisis, our top 3 priorities have been clear: assuring the safety, security and the well-being of our employees; ensuring the protection, continuity, sound operations and value of our business and its opportunity to continue to grow; and complying fully with the government orders issued in response to COVID-19. We have executed precisely on our priorities and are working hard every day to maintain this high II-VI standard of excellence.

Our China teams in collaboration with our global emergency response and business continuity planning team were able to bring all of our China facilities back to normal by the middle of March. It was a remarkable accomplishment for which the whole team deserves great recognition. Meanwhile, countless other examples of leadership and sacrifice are being staged across the globe now as II-VI heroes and heroines alike are giving it their all and their best. In fact, I am incredibly humbled by and deeply thankful for the way that our One II-VI team has come together in response to this crisis, and I assure you that we remain steadfast in our commitment to our II-VI mission and our impact on the communities and the world by providing products that enable all of us to be safer, healthier, closer and more efficient.

Our mission together with our II-VI vision of a world transformed through innovative materials vital to a better life today and the sustainability of future generations provide clear evidence of how our focus at II-VI is increasingly relevant to the world. In addition to meeting our top 3 priorities, we delivered an extraordinary third quarter. For Q3, we booked $840 million of orders and ended with a record backlog of $893 million. We delivered $627 million of revenue, and our margins on a GAAP and non-GAAP basis were strong. This performance is the result of growing and accelerating demand for our products across key end markets and continued success with our M&A integration efforts that is, in many facets, at least 12 months ahead of plan.

Our differentiated capabilities, extensive product and technology portfolio, global scale and diversified footprint allowed us to demonstrate our leadership position while serving the optical communications market, where strong demand led our growth. As the global leader in optical components, modules and subsystems, we experienced growth in demand in both telecom and datacom, driven by transceivers and optoelectronic components, ROADM modules and subsystems, combined with market share gains and the overall acceleration of legacy and 5G optical infrastructure build-out. This is the third consecutive quarter of strength we've recorded. So this trend started pre-COVID. The way the world works and delivers vital services, including telemedicine and distance learning, is changing rapidly and permanently. This evolution in human behavior is clearly stressing both the wireline and wireless infrastructure, and that is driving cloud operators and service providers to commit to significant infrastructure upgrades. Our strong bookings growth in this market is evidence of our leadership position and the long-term value of the combination of II-VI and Finisar that we envisioned almost 3 years ago.

Transceiver bookings were more than 40% above expectations and ROADM bookings grew 50% sequentially. That demand profile contains large orders placed for as long as a year, and the delivery of those bookings over a year's period of time suggests that this is the beginning of a long-term sustainable demand driven by an accelerated need to deploy new infrastructure worldwide. Our ramp of new products for 5G has accelerated as over 80 carriers rearchitect their networks to handle their 5 billion mobile subscribers who are quickly migrating to 5G. We've been told by 1 large OEM that U.S. traffic increased in the first week of the nationwide shelter-in-place orders by more than the increase for the entire prior year. I firmly believe that the beginning of a large and multiyear opportunity for II-VI is unfolding.

In addition to the profound changes we are seeing in the optical communications market, silicon carbide for RF wireless applications grew 75% compared to last year. Adoption is accelerating as -- and as an example, we are shipping under our large agreement announced last quarter at a faster rate than expected, driving a 5% growth sequentially. Our silicon carbide capacity expansion plans remain well on track for power applications as we believe that the market is still in early innings of a very long game.

For 3D sensing, we had record shipments again from our operations that center around our Warren, New Jersey wafer fab. It is noteworthy that those shipments were even higher than our Q2 shipments, which we think is remarkable at this point in the annual cycle.

As I look ahead, it's helpful to look back to provide perspective. We have clearly achieved the vertically integrated technology objectives we laid out at the time of our earlier acquisitions to address the emerging 3D sensing market as we have demonstrated a sustained high degree of production efficiency based on our cumulative experience gained while producing hundreds of millions of devices at very high yields and reliability. A top integration priority was to leverage our 3D sensing experience in our state-of-the-art Sherman, Texas compound semiconductor plant. I am pleased to announce that due to extraordinary examples of teamwork, collaboration and communication in a 7-day a week form since January 2 by our dedicated One II-VI team, began shipping from Sherman, Texas for the bold plan that I laid out for the team and described during our earnings call in November.

Now before I turn it over to Giovanni, I'd like to comment on the essential role of our emerging, vital life sciences business. Reliable diagnostic testing for COVID is based on a polymerase chain reaction or PCR process to replicate a small amount of DNA or RNA to generate a sample large enough for analysis. The II-VI life sciences business makes many of the key components for this equipment, including thin-film optical filters, thermoelectric thermal cycling engines and related subsystems. We are proud to be able to support the rapid increase in the world's capacity for COVID testing to combat this pandemic.

Now I'd like to turn it over to Giovanni. Giovanni?

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

Thank you, Chuck, and good afternoon.

Indeed, the qualification of the Sherman plant was a major milestone for our Compound Semiconductors segment. We are pleased to report the first production shipments for 3D sensing applications and expect the ramp to accelerate from this point forward and gain a meaningful share of the market. With our qualified epitaxial growth and wafer fabrication capacity, we are now well positioned as the only U.S.-based vertically integrated supplier of VCSEL arrays for 3D sensing on a 6-inch platform. Moreover, we have adequate capacity to serve the majority of what we understand the market demand to be.

Our communications business in the quarter was strong on all fronts. In Datacom, revenue for our components increased 63% compared to last year's quarter and remained steady sequentially. As we execute on our acquisition strategy to penetrate the merchant market with our previously captive products, we are pleased to report that we have received our first production order for indium phosphide components, which we have already begun shipping this quarter. By executing on our strategy, we have de facto increased our TAM by about $2 billion, and we have just begun to gain our share of such a market. As evidenced by the strength of the demand and the unfulfilled need for scalable indium phosphide and IC components, we accelerated the market introduction and qualification of our products for which I'm pleased to report a very exciting pipeline of design-in activities.

Revenue for transceivers was flat compared to the prior year and declined 9% sequentially. 100G remains the mainstay of the market today, representing almost 70% of the $3 billion high-speed transceiver market. As the transceiver market leader, this is and will continue to be a large portion of our business as we expect to see growth in 100G for at least the next 5 years. We believe that we were the first to supply 400G Datacom transceivers to the industry. And as we continue to invest in that technology, we expect to secure a major portion of that market segment as it grows.

The centerpieces of our telecom revenue are road and subsystems and components, which were also strong in the quarter. Sequentially, we only saw a 10% decline in revenue due to COVID on a 50% increase in orders. Demand was strong across the board for amplifiers, line cards and all enabling components, including passive optics and wavelength selective switches. In addition, 980-nanometer pumps and wavelength selective switches also experienced extremely strong demand for undersea applications. In fact, as we witnessed the acceleration of orders for our products for 5G applications and data center infrastructure, most of these manufacturing lines continue to be sold out. Products for semiconductor capital equipment overall continue to be in high demand, growing 12% sequentially, driven by the global logic semiconductor market and undaunted by COVID. We expect to see the growth will continue over the next 12 months as our customers build the next-generation fabs worldwide.

With our technologies and products, we are enabling the transformation of the back end of the line of these fabs as we also expand our materials offering from EUV optics into motion control components for the front end of the line. Our team keeps innovating and delivering high-performance products to this market segment irrespective of COVID.

In aerospace and defense, our revenue grew 25% year-over-year and was stated sequentially. Our advanced materials, electro-optic components and subsystem platforms combined with semiconductor lasers are central to our growth strategy in our aerospace and defense segments, namely satellites, contested space, hypersonics and directed energy. It is also worth mentioning that we were honored to receive the Raytheon 2020 Supplier Excellence Award. Industrial remains steady overall on a sequential basis. Demand for key enabling products, particularly laser engines, grew 17% sequentially for new laser system builds though the aftermarket was somehow soft. We were pleased to see a resumption in new laser builds in spite of the incredible impact of COVID on many industries, such as automotive. This is likely due to continued activity in those companies that were considered essential and continue to operate.

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

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

Thank you, Giovanni, and good afternoon.

Since our last call, we've had some very notable achievements. Just to mention 5 of them: the strongest order book we ever achieved; only a 6% decline in revenue or about half of the minimum $50 million in revenue we anticipated for COVID compared to our strong December 31 quarter's revenue; excellent shipments from Warren and the beginning of shipments from Sherman; non-GAAP gross margin and non-GAAP operating margin at or above II-VI's stand-alone margins at the March 31, 2019 quarter; and finally, strong liquidity management ending in $746 million of available liquidity and $36.5 million of positive free cash flow in the quarter.

We really do have a very dedicated team. During the quarter, the total revenue of $627 million was split: 68% in communications, 11% in industrial, 7% in military, 6% in consumer, 5% in compound -- in semiconductor capital equipment, and the rest is in the other markets. The margin progress was very good in the quarter. The non-GAAP gross margin was 38.3%, advancing 200 basis points and above the II-VI stand-alone gross margin of Q3 last year. The operating margin on a non-GAAP basis was 13.8%. We had a favorable mix this quarter affecting both margins and that does vary from period to period. GAAP EPS was $0.06, and the non-GAAP EPS was $0.47 with the after-tax non-GAAP adjustments of $38 million in total. We had 93 million diluted shares in the quarter. GAAP return on sales was 0.9%, and non-GAAP return on sales was 7%. The return on sales is lower than II-VI experienced stand-alone due to the unusual tax effects of purchase accounting in this quarter.

At the segment level, the adjusted operating margins were 13.4% for Photonics and 14.6% for Compound Semiconductors. Photonics benefited from operating efficiencies and the richer mix, including more than doubling its submarine pump sales again this quarter year-over-year. Compound Semis also benefited from its strong sales of VCSEL arrays; the qualification of the Sherman, Texas fab; and the commencement of commercial operations in Sherman. For operating expenses or OpEx, the total was $177 million on a GAAP basis and $154 million on a non-GAAP basis compared to $168 million in the second quarter of fiscal year '20. Our focus on OpEx has been intensive and will continue, and I'll talk more about synergies in a minute.

In our non-GAAP adjustments, you will see a great deal of movement. This is due to the continuing work towards finalizing our purchase accounting. Amortization in the quarter was $5.7 million, the result of adjusting to the forward run rate of $20 million of amortization per quarter, down from our previous quarterly estimate of $33 million. We had $8.5 million of onetime depreciation benefit in the GAAP results that we excluded from the operating performance as shown in the non-GAAP table. We expect our run rate depreciation to be about $43 million a quarter on the current fixed asset level as compared to $53 million previously. But this will, of course, increase with the acquisition of additional fixed assets. These changes in amortization and depreciation were part of our continuing work to report the fixed assets, intangibles and deferred income tax liabilities of the Finisar acquisition at fair value. At March 31, we were about halfway through the 1-year measurement period that will conclude on September 23, 2020.

Stock comp was $14.4 million in the quarter, and transaction expenses including severance were $5.9 million. Our quarter-end backlog was a remarkable $893 million, consisting of $518 million in Photonics and $375 million in Compound Semiconductors. This compares to last quarter's backlog of $681 million for the whole company, with $346 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 $28 million. For the combined company for the year, we are expecting CapEx in the $125 million to $140 million range. Our operating leaders have done a great job on yields and shift expansion to allow us to moderate new capital expenditures across the company. Cash interest expense was $21 million, and the -- and all debt-related expenses on the P&L were $28 million for the quarter, including the noncash amortization of the convert option and the fees to complete the financing. Debt decreased $21 million with repayments during the quarter on the revolver and term loans. The total debt -- the total expected debt service payments for the next quarter are $25 million: $19 million in cash interest and $6 million in noncash-related expenses. In addition, the required principal repayments will be $17 million in Q4.

Our cash is $388 million. Availability on our revolver is $358 million, including outstanding letters of credit, and our net debt position is $1.9 billion. Our net debt leverage ratio on the basis of our credit facility is 3.8x. The tax expense and tax rate are both rather unusual in this quarter and will be for the rest of this year as we true-up purchase accounting for the Finisar acquisition, including all of the tax attributes. For Q4, we expect a tax benefit of approximately 15% to 18% on the quarter's income and, for next year, something more typical in the range of 16% to 19%.

Regarding our work on synergies, we are tracking well against our target of $150 million in annual cost synergies within 3 years after the close of the transaction. At this point, we have realized $43 million compared to the expected $35 million halfway through the first year. Given the intensive focus on OpEx, we will likely deliver in the first year at least 50% more than the year 1 target of $35 million.

Turning to the outlook. The revenue for the fourth fiscal quarter ending June 30, 2020, is $650 million to $700 million and the EPS on a non-GAAP basis of $0.50 to $0.70. This is at today's exchange rate and at an estimated 12% tax benefit. The non-GAAP items in EPS totaled $0.48, including the pretax amount of $16 million in stock compensation, $20 million in amortization and $8 million in costs to facilitate the integration. The share count to be used is 95 million shares. The actual dollar amount of non-GAAP items, the tax rate and the exchange rates are all subject to change.

Before we go to the Q&A, as a reminder, our answers today may contain forecasts from which our actual results may differ due to a variety of factors, including, but not limited to, changes in product mix, customer orders, competition, changes in trade and tariff regulations and general economic conditions. (Operator Instructions) Kathy, you may open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question is from Tom O'Malley of Barclays.

Thomas James O'Malley ***Barclays Bank PLC, Research Division - Research Analyst***

Congratulations on some really strong results, particularly in these times. I guess my first question was around the really strong backlog you had in the quarter. Clearly, a lot of strength coming from Photonics and within that, the transceiver business. What gives you the confidence that these really strong orders are long-lived for the remainder of the year and not just a function of people trying to get product now? And can you describe the health of your supply chain as well as your customers with regard to everything that's going on with COVID there?

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

Tom, thanks for your question. Yes, I'll take it in 2 parts. For the first part of your question, we have great confidence based on our engagement with our customers that the order book that we see today and in discussions with them about their longer-range forecast, we have every reason to believe that it will continue.

Now we have a whole set of challenges to be able to work through, to be able to keep pace with such a large ramp. One of them is in the supply chain. And as the largest optical communications components and subsystem supplier, we have a great supply chain management organization and a great set of strategic suppliers that are doing business with us. And it's going to be the usual when you're going up a ramp like this, there will be some shortages and some rework that needs to be done. And the full utilization of our capacity to have the maximum service to our customers and the maximum generation of revenue and profit is what we're focused on. Okay?

Thomas James O'Malley ***Barclays Bank PLC, Research Division - Research Analyst***

And then just a follow-up. Congratulations again on getting the Sherman facility up and running. In terms of margins, you guys had previously talked, I think, about an $18 million headwind to operating margins just based on that facility. Can you talk about where you see margins trending given that's up and running? Clearly, it's going to be a big tailwind. Can you just talk about what that's going to do for your business here in the second half in particular?

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

Well, first of all, we had some very, very nice margins in this quarter, but on 1 quarter of strong margins, it's tough to extrapolate and say that's where we'll stand. But generally speaking, when you look at the things, that should affect our margins going forward, obviously, mix is one of them, and that's subject to change. But shipping from plants that had not been shipping, so in this case, Sherman, that's a big lift on margins. The continued strength in silicon carbide is helpful as well. And then I'd say the next thing that would be in the mix that would potentially lift margins, so it may not quite be with us yet, is the pickup in the industrial market, given the strong margins in that segment overall. Generally speaking, though, I would say that with respect to our overall photonics business and communications, we have been able to post, and we saw this in 2016 and '17, good margins in our business on extremely good utilization when the volume is high. So I would imagine that probably, if you think about the margins last quarter, at least the gross margin, which was at 36%, it's probably a range of somewhere between 36% and 39% as we go forward.

Operator

Your next question is from Mark Miller of The Benchmark Company.

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

Congratulations on your quarter. I'm glad everyone's been staying safe. You mentioned you had some market share gains. Can you provide a little color about that?

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

Mary Jane, do you want to take that one?

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

Sure. Well, I think obviously market share gains are always challenging with respect to being very, very precise about them. But as Chuck mentioned, when he was asked the question about what makes us confident that the bookings we have aren't just a stock inventory next quarter, I'd say that the engagement that we have with our customers and our understanding of increases in share awards give us an indicator that we believe that we are beginning to gain share in some areas. Giovanni, do you want to add anything to that? Or Chuck?

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

Yes. I can say that the growth rate that we have experienced in 3D sensing over time, we believe that's due to a share gain because we don't think the market is growing that fast. So that's another area I would mention.

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

Okay. And the follow-up question, your competitor mentioned last week in the 3D sensing area, there were some program delays. I'm just wondering if you can comment on that. Or is that an opportunity? Or what's that a reflection of?

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

Mark, I'll take that. I'm not aware of program delays. I mean at least to what we are concerned, we are engaged with, so everything is as planned. At least we have no official communication by anybody about anything being delayed.

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

The only thing I would say is, as a general matter, the 3D sensing market, as we've talked about many, many times before, has been developing more slowly than might have been anticipated when people first started thinking about it. But beyond that, of course, Giovanni has hit the nail on the head.

Operator

Your next question is from Tom Diffely of D.A. Davidson.

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

Just curious, when you look at the Warren and the Sherman facilities, are there products that -- are you doing the same products from each of those facilities? Is there overlap or redundancy? How do we view those 2 different facilities going forward?

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

Okay. So yes, they're all VCSELs, particularly VCSEL arrays. Even if in Warren, we also still make amplifiers on gallium arsenide, RF amplifiers. But the -- and also, I want to remind that the Sherman facility is also producing VCSELs, high-speed VCSELs for datacom. But with regard to, generally speaking, 3D sensing, we do have a small overlap, which will disappear over time.

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

Okay. That's helpful. And then Mary Jane, when you look at the $45 million in cost synergies to date, above your expectations, where are most of those coming from? Is it COGS or OpEx?

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

Well, first of all, we've made great progress on the COGS synergies, which many of you will remember are largely in the supply chain. Oftentimes, so that in terms of work with suppliers, that's moved along at quite a pace. Having said that, it does take time to materialize into the P&L. So notwithstanding some very excellent work there, that's probably less what's affecting the P&L, and it's more in OpEx right now. Obviously, some of it has been in the reduction of staff, in Chuck's new organization, as well as just looking at more efficient ways to do things, helped along here a little bit by even rethinking what we might have thought as synergy targets based on how we've all learned to work pursuant to COVID. So I'd say at this point, in terms of realized synergies, they're probably -- there are absolutely some in the COGS, but it's probably more in the OpEx.

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

Okay. And then your long-term view of that $150 million, same percentage split between COGS and OpEx as you had before? Or has that changed?

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

Yes. I think for now, yes. I think, obviously, as I just said, it's so interesting to have all been forced almost to learn to work a different way. That may change what we elect to do as time goes on. But we've never met a synergy we didn't want to take. So we'll keep you abreast of what that split is over time.

Operator

Your next question is from Jim Ricchiuti of Needham & Company.

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

Just a couple of questions on the industrial business. I was struck by the comment, if I heard it correctly, that you saw good growth in new industrial laser deployments. But it sounds like the aftermarket was weaker. So it seems like that suggests lower utilization rates. I'm trying to square that.

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

Okay. I'll take it since I read that part, Jim. So thanks for the question. So the strength primarily comes from China. So when we say new laser builds, we are primarily referring to China where we sell optics and laser pumps, seed lasers and all kind of other products. And those are -- obviously, these are new products, so they are mainly for new laser builds. So clearly, it's about new laser builds. On the other hand, the aftermarket, which is, by the way, still primarily dominated by CO2 lasers, we see -- we have experienced a decline over the past couple of months, which is to nobody's surprise, I guess, because probably, as you can imagine, laser utilization is lower for some of these factories that utilize lasers. So the 2 kind of balance each other a little bit. But again, some products going to new lasers, there's no doubt about it. And the problem is they go in existing lasers deployed after market had declined. But the new products are definitely for new laser builds.

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

Got it. And you answered that question. The second question. With respect to -- we've been hearing anecdotally of some disruption in the Malaysian electronics supply chain. I'm wondering, just given the fact that you have a fairly large facility there, have you seen any impact on your operations there? Or are you deemed an essential supplier to that market and have been largely unaffected?

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

Largely unaffected, Jim -- not largely, but unaffected. We -- the team there in Malaysia also have done an extraordinary job. So we are full speed ahead.

Operator

Your next question is from Dave Kang of B. Riley FBR.

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

My first question is regarding Sherman qualification. Can you tell us if that's with a North American customer?

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

Dave, this is Giovanni here. I think we have a number of customers in that fab, so I don't want to go specify which one we will qualify. But it's a large customer, probably the largest.

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

Got it. And then regarding fiscal fourth quarter revenue growth, can you just go over some of the assumptions between comm, industrial and 3DS and within comm, maybe if you can break it up between telco versus datacom?

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

Well, so we're actually not going to do the guidance by end market. I would say if you just think about what we have here in the third quarter, given the strength that we saw in communications from a bookings point of view, and I think typically, what we see in the communications infrastructure, when that market is rising, it does tend to rise without a ton of seasonality. So it's probably reasonable, you would expect to see growth there. With respect to, again, what has been a typical pattern, Q4 has not actually historically been a big market on consumer. That could change. We'll see. And then I think the rest of it just really depends on kind of how people see seasonality and how much they may be in a position to recover from any diminution of activity they saw in the third quarter. But generally speaking, given that we saw some nice bookings largely across the board, I'd say it really comes down to what individual customers think they're prepared to do and able to do as they begin to emerge from COVID to address demand they're seeing.

Operator

Your next question is from Paul Silverstein of Cowen.

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

If you all addressed this fully in your prepared remarks, I apologize. I know you spoke about communications. But I'm hoping that you could give us the organic growth, either looking at II-VI and Finisar pro forma as if they were together a year ago or alternatively just looking at apples-to-apples at II-VI's historical business. And obviously, I'm referring to the breakdown in datacom and telecom, what type of growth that would look like on an organic basis in the quarter before I give you a follow-up.

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

So I actually missed the first couple of words. You're asking us to split the growth between organic in the...

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

Well, I'm trying to look at it on an apples-to-apples basis. So whether you look at combined Finisar and II-VI as if they were combined a year ago and look at the growth for datacom and separately the growth for telecom. Or alternatively, just if I just isolated II-VI -- I assume you can't isolate out II-VI's telecom from the telecom piece of Finisar, so we looked at the growth. I don't know if you looked at it this way, but looking at the growth as if the 2 companies were combined, what would growth have been for telecom, what would growth have been for datacom?

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

Yes. Got it. Okay. So first of all, in the 10-Q, on note 3, is the pro forma footnote, so you guys can all see that. And because you have Q2 last quarter, there's -- it's a little bit easy for you to back in there. There's just a little bit of math you need to do. But net-net, on a pro forma basis, sequentially, the combined communications business was down 8%.

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

I appreciate that. But Mary Jane, perhaps a bridge too far, but I'm hoping that you could give us datacom separately from telecom, what the year-over-year growth would be -- would have been.

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

So let's just do year-over-year for the combined business. So for the combined business, pro forma, it would be about 12. I don't know that we can do the split between datacom and telecom. Let me take a look and see. But Giovanni already talked about some of the growth in components, most of which would be organic, right? So if you took the growth in components that he talked about and back that out, that would probably get you to a good number -- a reasonably good number on what was organic. But at this point, I'm not actually in a position to tell you that.

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

So let me ask the follow-up, which tries to go to the same place. If we look at demand versus supply chain constraints versus the supply chain impact, clearly, the qualitative takeaway from your commentary is that demand is very strong pretty much across the board. But I'm hoping we could get some more insight on that issue in terms of how much is supply chain taking -- the supply chain limitations, how much is that taking away from both the quarter you just reported, more importantly, in the quarter looking forward, how much is that impacting your ability to recognize the demand that is out there? And if we just isolate on demand, it sounds like it's very healthy, but I want to confirm that.

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

Okay. Paul, this is Chuck. Mary Jane, I'll take it up. With regard to Q3, if I understand your question, it's to what extent any supply chain shortages impacted our ability to deliver in Q3, was that your question, Paul?

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

Correct. And more importantly, what's it going to impact in Q4, Chuck, what the limitation can impact.

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

Okay. Yes. I would say, again, I want to really acknowledge our supply chain, global supply chain organization. They've done a fantastic job. They were able to -- along with our strategic suppliers, which I also greatly appreciate, they were able to limit to a very small number, low single-digit millions of dollars of revenue that we were not able to fulfill because of the supply chain issues, and also, our customers have been fantastic with us, working through the constraints with us so that we can maximize the utilization of our assets and then maximize the benefit for our customers as well.

In Q4, Paul, we're halfway through Q4. And based on our shipments in April and the overall tempo through our global factories right up until last night, we always have a chance that we may have some pickup, and we may blow a tire, I guess, based on a supply chain issue. But at the moment, we're staying focused on being able to deliver within the guidance that we announced tonight, and that guidance does take into account some, let's call it, supply chain uncertainties. Okay?

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

Okay. I appreciate that.

Operator

And your next question is from Meta Marshall of Morgan Stanley.

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

Great. Maybe just one last question on that. Just given supply chain constraints for others around the space, understanding you're not seeing some of the same issues. But do you think some of your strength in telecom is from share gains from others? Or you just kind of expect that you just -- this is what true demand would have been? And then maybe second for Mary Jane, just diving into a gross margin uplift. Understanding you're ahead of synergy targets, but just any sort of split between how much of the uplift either quarter-on-quarter or year -- or I guess, quarter-on-quarter was due to synergies, mix and then just getting facilities up. Or just any ballpark there would be helpful.

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

Okay. So starting with the last question first. I'd say -- I mean I'm not sure I can give it to you hyperly precisely, but I would say, generally speaking, we're probably seeing mix as the main driver of the gross margin. The supply chain synergies are absolutely beginning to come in, but they do take a while to get, as I said, through the P&L. I would also say that one of the other things that's probably benefiting too is the -- which would be permanent, is how we rethought about the ongoing depreciation from a purchase accounting point of view on the margin, which, as we said, is probably a drop on an ongoing basis in the neighborhood of about $10 million. So that's the input with respect to the margin. With respect to the share gain, shall I give that to you, Chuck?

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

Yes, absolutely. Thank you, Mary Jane. Meta, I would say maybe in a few categories. One, in our ROADM line card components, I believe that the strength of our customers' business and the strength of our portfolio have contributed to what you're seeing in telecom. Also, our undersea qualified portfolio of both pumps and receivers and passive components, including wavelength selective switches, has really shined in Q3. So that's the second one. And our transceiver team, especially as it relates to our order book, is really coming on strong, both in telecom and in datacom.

Operator

Your next question is from Simon Leopold of Raymond James.

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

I want to see if you could talk a little bit about your expectations for how your 3D sensing business might trend through the year. In that I'm thinking about normal seasonality, if such a thing were to exist, as down in June, strong in September and then down in December. But this year seems to be clearly very different, and you're ramping the production out of Sherman. So I'm wondering whether or not you expect up in June, up in September, up again in December, or whether there's some seasonal aspect we should be taking into account.

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

Okay. Simon, thanks for the question. This is Giovanni. First of all, your -- forecasts do change. So what we expect may just be different than what's going to happen, of course. At this point, we don't anticipate anything different than the past, let's say, the past years or the past ramps. Our focus is in gaining share. Our focus is to execute, gaining share and go through the volumes that the customers are forecasting to us. So it's a really short-term kind of view of the market, in my opinion, looking at 1 month or 2 months. So we are here for the long run, and we want to be the leader in this market. It will take some time to get there. But so far, we're moving 1 direction only.

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

And just as 1 follow-up. In terms of the opportunities you've talked about from 5G, particularly looking at the optics, not the silicon carbide portion, but the optics used in front-haul/backhaul, it sounds like that business is growing and gaining traction a little bit faster than you expected. Could we get an update on how you see the contributions evolving over the next, let's say, 1 year or so?

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

Let me start, Simon. When you -- I'm not sure exactly what you said about our expectations of maybe faster than what we thought. We've been in this -- we've been in a strong demand for 5G for optics, for micro-optics and passive components well before the acquisition of Finisar. And we've been clear about the capacity investments and expansion we've made. Now we have a wider portfolio. And over the last 6 to 12 months, in addition to our passive component portfolio now as a full line supplier, we are seeing the turn on since the early part of this calendar year, a step-up in demand around the world for 5G. And we think it's just beginning.

Operator

Your next question is from Sidney Ho of Deutsche Bank.

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

Great. Congrats on the good quarter and the outlook as well. Just a follow-up on the last question on 5G. Obviously, you guys have done well there, but we've been hearing some mixed signals in terms of who's ramping, who's not ramping. Curious if the strength that you're seeing is more broad-based, or is this more specific to certain regions? And how does that compare to your expectations maybe like a quarter ago?

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

I would say it's a global effect. And for sure, there'll be -- some parts of the world and some suppliers have been out in front. But this is not confined to 1 customer, in 1 region, Sidney.

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

Okay. That's helpful. For my follow-up question, regarding the Department of Commerce rules, I don't know if you have a chance to look at that. I just want to hear your thoughts to see how that may impact II-VI. And maybe, as usual, I ask about silicon carbide. A lot of the end demand will likely end up in China electric vehicle or 5G base station. But is there a potential military use angle there as well? We'd love to hear your thoughts on that.

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

Giovanni, do you want to take that?

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

I wasn't sure about the question about the military on silicon carbide. But there is no doubt that China is a large market for us. So far, we have not really been affected for a number of reasons, a combination of location of our manufacturing and our location of our general infrastructure, R&D teams and so forth. So very hard at this point to see what's going to happen in the near future. We do plan to have some processing of silicon carbide in China as we believe that will help our costs as well as our entry into the China market with the platform. But as you probably know, we'll not be able to do anything other than that outside of the United States. So we'll be limited in terms of the growth to remain in the United States. So if you can repeat the question, Sidney, about the military, I wasn't sure about the relationship between silicon carbide and military.

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

Yes. So the question on silicon carbide is obviously some of this could be used in military, even though the customers you are dealing with right now are talking about using it in electric vehicles or base stations. But based on the new rules, it's all based on the potential military use of that particular product. So that's how it'll come in, trying to see if you're concerned about some of the products you may not be able to sell to China because of this potential military use.

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

Yes. Well, I mean that's a general dual use risk for many technologies. You mentioned silicon carbide, I'm going to mention high -- our energy lasers. A high energy laser weapon is nothing more than various low so-called SWaP industrial lasers. And so it's a challenge that we face. But I think we -- our compliance team is helping us navigate through what we need to do to follow the law. And I think the U.S. market for those applications is going to be very interesting. In fact, our -- even our own gallium nitride on silicon carbide products that we'll make in collaboration with our partner in New Jersey could have a potential for the military market in the U.S.

Of course, we'll not be able to sell them outside of the United States. So -- but yes, there will be a limit of what we can do with the platforms we have, no doubt about it. I guess that's true for everybody that is in the United States.

Operator

Your next question is from Samik Chatterjee of JPMorgan.

Joseph Lima Cardoso ***JP Morgan Chase & Co, Research Division - Analyst***

This is actually Joe Cardoso on for Samik Chatterjee. My first question is regarding your realized synergies. Obviously, above the $35 million target that you guys put out there for the first year. I guess I just wanted to get a clarification around those incremental synergies. Would you bucket those as pull-in from year 2 or 3? Or are those incremental to your targets?

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

It's probably a combination, I'd say.

Joseph Lima Cardoso ***JP Morgan Chase & Co, Research Division - Analyst***

And then I guess just on a follow-up there, what -- as you stand today, are you comfortable with the $150 million target? Or would you -- are you guys more comfortable raising that target in the future? My question is like if you guys are seeing more today, what's holding you back from raising that target?

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

So we're comfortable with the $150 million. I think given that some of the synergies are challenging to get and frankly we're 2.5 years to go, I don't think I'd move the target now anyway.

Joseph Lima Cardoso ***JP Morgan Chase & Co, Research Division - Analyst***

Got it. And if I could, just one last thing on the synergy. Obviously, there's top line synergies that haven't necessarily been quantified. I'm just curious on the progress that you've made or any like what new avenue you guys are exploring relative to top line synergies and if there's been any progress made on those.

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

I think Giovanni already summarized those, especially in the main one that we had talked about since the time of the acquisition, which is the beginning of the selling of indium phosphide components. And as he reported during his remarks, we have actually begun shipping that. So I think it's early to put a target dollar value on that. But that is a big deal to have got qualified and start shipping, the indium phosphide components as individual components this early in the acquisition combination. That's what Chuck meant about some aspects are as much as 12 months ahead.

Operator

Your next question is from Christopher Rolland of Susquehanna International Group.

Christopher Adam Jackson Rolland ***Susquehanna Financial Group, LLLP, Research Division - Senior Analyst***

Congrats on the results, and congrats on the Sherman qualification. And regarding Sherman, perhaps you guys can talk about how you view the TAM for the 3D sensing market. And what kind of share you guys think you can capture exiting this year and perhaps 3 years down the road?

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

I don't know that we would necessarily predict share that far out. But I think pretty much what we've said fairly consistently is that we believe that the TAM from a consumer point of view for 3D sensing is in the neighborhood of $1 billion. And originally, when we talked about that back in 2017, we expected that to be materializing in the 2020 year. And thus, our comments all along that the market has been developing more slowly than we expected. But we certainly would expect to at least have our fair share of that market. Giovanni, do you want to add anything?

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

Yes. I mean we -- our investments are to become the leader in that market. So anything bigger than 50, I like that.

Christopher Adam Jackson Rolland ***Susquehanna Financial Group, LLLP, Research Division - Senior Analyst***

Okay. Yes. Just any sort of update towards the exit rate of this year, market share will be great. But if you don't have that, that's fine. But as a follow-up, it did sound like you had some really nice booking trends here. So I guess I have 2 questions. First, was there anything about the linearity of the bookings? Did it accelerate into April and May? Or was it just consistently strong out there over time? Were there any irregularities?

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

I wouldn't say so. We knew we would get from you guys the question of whether or not these bookings were all about restocking inventory. So we spent a good amount of time looking at the timing of the bookings, which does tell us something about what they're likely for. Obviously, when you're a component manufacturer, to some extent, your knowledge of where your materials are going isn't perfect. So generally speaking, I would say it looked like what would normally be an acceleration for a market that was beginning to rise. And I would also say that, at least from what we can see, the April bookings are not walking back the trend -- I don't know that we're going to have $800 million of bookings in the 6/30 quarter, but I would say that we didn't see a reversal, significant de-bookings, any of that sort of stuff that would cause us to be spotting strange things in the bookings we just reported.

Operator

And your final question is from Jed Dorsheimer of Canaccord Genuity.

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

Superb execution, really something to be proud of. I guess my first question on the silicon carbide. I'm just curious, the landscape seems to have shifted a bit with Dow's sale to SK. Curious what your thoughts about the shifting landscape there. And then I have a follow-up.

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

Giovanni, would you like to -- Giovanni or Chuck, would you like to do that?

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

Yes. I'll let Chuck, you start, I'll finish. What about that?

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

Okay. Jed, thanks for joining us today. The -- for us, the change in ownership doesn't add a dynamic to the marketplace in the short term, but it could in the long term. And we believe that this marketplace, like many people believe, and I think you do, too, that in this century, the electrification is going to be a main driver of sustainability for the world. And in the short term, there's likely to be -- and in our modeling and my thinking, likely to be some modest gains and possibly have the market move sideways while automotive companies rethink their priorities in the short term. But overall, our sense from talking with customers is that their interest and their activity that's focused on silicon carbide-based power electronics is not wavering. So the -- for us, we're a great competitor, and we love competition. And we think it will be healthy for the marketplace, and it will only end up having the overall effect of driving, in our estimate, greater demand. Okay?

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

That's helpful. With respect to the silicon carbide, just staying on that subject, it sounded as if the demand in near term is -- or let me ask, how is the demand split between application for RF versus electrification or inverter-type applications in EVs?

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

Giovanni?

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

So we -- yes, this is Giovanni here. So we had -- like in the last quarter, we have experienced a decline in the conducting substrate in the power electronics, substrates for power electronics. And we were able to retrofit our growth reactors to grow the semi-insulating substrates. And we are seeing that to continue over this just recent quarter so that the -- even if at some point in the future, we know that the power electronics demand will be much larger than the RF, that's not the case today. And as we said during the script -- in the script that the acceleration of 5G, I would say really worldwide, isn't really -- it's not just about China, but also other OEMs and other carriers worldwide can continue to get ready and ramp these 5G deployments. We have seen an increase in the RF, which has been really timed very well. As you may recall, we were sold out for several quarters in terms of capacity. So the decline in power electronics, I mean, was not welcome, but at least was timed perfectly to enable us to grow the RF business.

So all in all, I think we have been fortunate about the timing. So we were able to refocus on quality improvement and all the other things that we need to do to be -- to continue to be ahead of the competition even if we'll come, as you said, maybe from Korea in the future.

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

Sure. I think given the time, we should probably finish the Q&A at this point, and I'd like to just, for a minute, turn the mic back to Chuck.

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

Okay. Thanks again, Mary Jane. Thanks again, everyone, for joining us. Overall, for the quarter, it was a tremendous performance during this COVID outbreak. I'm proud of our worldwide leaders who put safety first, collaborated early on to provide a business continuity and emergency management plan, both internally and with local officials, and who are carefully tending to the needs of our employees.

Finally, I would also like to thank the growing list of our customers who value our technology, scale and differentiation as well as all of our other business partners, investors and especially our employees who were enthusiastically aligning around our strategy as we continue the hard work that's always associated with being a global market leader. We will continue to position II-VI for the tremendous growth opportunities ahead for II-VI, while driving long-term shareholder value and while serving a vital role in the world. We look forward to updating you in August, and this ends our call today. Good night, everyone.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.