Conference Call Prepared Remarks
Coherent, Inc. Reports Fourth Fiscal Quarter Results
Bret DiMarco – EVP, General Counsel & Corporate Secretary

Thank you and good afternoon everyone. Welcome to today's conference call to discuss Coherent's results from fourth fiscal quarter and fiscal 2017.

On the call we have John Ambroseo, our President and Chief Executive Officer and Kevin Palatnik, our Executive Vice President and Chief Financial Officer.

I would like to remind everyone that some information provided during this call may include forward-looking statements, including, without limitation, statements about Coherent's future events, anticipated financial and operating results, business trends and the expected timing and benefits of the integration of our recent Rofin-Sinar transaction. These forward looking statements may contain such words as "expects," "will," "anticipates," "intends" or referred to as "guidance." These forward looking statements are only predictions and are subject to risks, uncertainties and assumptions that are difficult to predict and may cause actual results to vary significantly. These forward looking statements reflect beliefs, estimates, and predictions as of today, and Coherent expressly assumes no obligation to update any such forward looking statements.

For a description of risks and uncertainties which could impact these forward looking statements, you are encouraged to review Coherent's periodic SEC filings including its most recent Form 10-K, Form 10-Q and Forms 8-K.

I will now turn the call over to John Ambroseo, our President and Chief Executive Officer.

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John Ambroseo, President and Chief Financial Officer

Thanks, Bret. Allow me to add my welcome to our fourth fiscal quarter conference call. As reported in today's press release, Coherent set new records in our fourth quarter and full fiscal year for sales, gross profit and EPS. We also generated significant cash from operations that enabled several voluntary prepayments during fiscal 2017 against the debt taken on to finance the acquisition of Rofin-Sinar. These results were achieved through the hard work of colleagues across the company who developed, delivered and supported high value-added products to our customers.

We will be releasing our Form 10-K in a few weeks. One of the most eagerly anticipated metrics is backlog and its extrapolation to bookings. We're going to end the mystery. Coherent achieved record bookings in fiscal 2017 of $2.03 billion with a corresponding book-to-bill of 1.18. The commercial markets accounted for all the order growth.

Microelectronics orders increased by double digits for the full fiscal year. The FPD market contributed in multiple ways. New system orders were robust and highlighted a shift towards Gen 5 and above. The LDU service business grew along with the installed base and utilization rates. We also received approximately $70 million of orders for ultrafast and CO2 lasers used in glass and film cutting for smartphones. The latter were tied to the launch of new handset models.

I would like to reiterate and expand on comments from the last conference call. New ELA shipments for fiscal 2018 are fully committed. Growth against fiscal 2017 occurs in three ways: a mix shift towards larger format tools, fully utilizing existing capacity in fiscal 2018 - this wasn't the case in 2017, and an increase in service revenue. FPD orders taken in 2018 will ship in fiscal 2019 and beyond.

We have fielded a number of questions at recent conferences regarding microleds and LTPO displays. The promise of microleds is that they can produce higher brightness while consuming less power than OLEDs. They also have a wider operating range than LCDs or OLEDs. The biggest challenge is manufacturing. Unlike OLEDs that are based on organic emitters, microleds rely on inorganic material systems like gallium nitride. Each color in an RGB emitter cluster is grown using a different material set in MOCVD reactors. The emitters are removed from the growth substrate and transferred to a display substrate using pick and place tools. A typical high-definition, 5.5" handset requires more than 3 million pick and place operations. This is far more process intensive than an already complex OLED production method and costs more than 10X a similar OLED. As a consequence, it is unlikely that they pose a market threat to OLEDs in the handset market. So where might microleds play? There has been early interest for wearables, AR/VR microdisplays due to brightness and power consumption and in large format emissive displays like theater screens where the scaling is not limited by chamber size.

Low-temperature, polycrystalline oxide or LTPO was first demonstrated by Japanese researchers more than 15 years ago. Published research suggests the annealing process helped stabilize the material rather than augment its properties. If this is the case, then it remains an inferior material to LTPS. One Japanese manufacturer recently indicated that an LCD/LTPO display could alleviate some of the current supply constraints on OLEDs. It is not clear if there is any validity to this claim or if it is their hope to overcome their absence from the OLED market.

The semicap market was very strong in fiscal 2017 with orders growing well into double digits on an organic basis (i.e., excluding the small contribution for legacy Rofin). Chip manufacturers are investing capex for node reductions for logic devices to serve the mobile, server and AI markets. The DRAM and 3D NAND markets remain very tight, which has led to capacity expansion. And finally, IoT devices have driven service demand for legacy lines. The 2018 outlook from Gartner is for a similar level of capex to 2017, although it may be shifted in favor of logic devices as memory supply comes in line with demand.

The advanced packaging market continued its mini-resurgence with the highest quarterly bookings over the last few fiscal years. Capacity is being added to via drilling and laser direct imaging, which are both tracking semi cap investments. Perhaps more importantly, a front runner may be emerging for 5G circuit boards. If you're not familiar with them, they're called substrate-like-PCB and allow for thinner packaging. They're a shrunken FR4 board with a fiberglass core wrapped in resin and wrapped in copper cladding. The via diameters tend to be 50 microns or less, which is at the edge of CO2 drilling, so alternate lasers are being explored. We'll provide periodic updates as the technology is further developed.

Materials processing orders grew by almost 3.5 times on a year-over-year basis due to the acquisition of Rofin-Sinar. Annual core market growth was in double digits with a corresponding book-to-bill that was well over one.

There were several additional trends that drove our annual results. A large portion of our fiscal 2017 multi-kilowatt fiber laser sales went into battery welding for electric vehicles and energy storage systems (i.e., whole house back-up batteries). The potential for this market is obviously large with a projected long-term CAGR in excess of 20%. As an example, governments are signing up to the 30@30 goal, which is 30% electric vehicles by 2030, and/or announcing future restrictions or bans on gasoline and diesel-powered engines. Automakers and Tier 1 suppliers are committing large amounts of capital in the tens of billions of dollars to develop and deploy next generation EVs.

Coherent is one of the leading suppliers of fiber components and semiconductor pump modules to the fiber laser market. The Chinese domestic fiber laser market, where we enjoy strong market share, has been especially active for 1 to 1.5 kilowatt fiber lasers used in mid-power cutting workstations, which appeal to small and mid-size manufacturers.

Increased adoption of laser-based processes is also contributing to the business. The introduction of new flagship smartphones led to significant demand for lasers used in packaging, marking and cutting. We expect this trend to continue as other smartphone players release new models. Product identification and traceability as well as inventory management have long relied upon laser marking. We are seeing the portfolio broaden due to new materials that respond to different wavelengths of light and new requirements around quality and clarity of the imprinted information. Consumer packaging also remains a key piece of the business with speed of the line and size of the package or feature being the two key variables.

Additive manufacturing has been an active area and represents a potentially large growth opportunity. Most of the attention has focused on metal parts fabrication given the size of the market as well as the cost and inventory benefits. We are also enthusiastic about the opportunities in cladding and plating. Laser-based cladding is used in multiple industries such as oil and natural gas exploration, mining and agriculture to coat metal parts so that they withstand very aggressive operating environments. The electroplating industry is facing bans in Europe and China due to hazardous wastes challenges. A high-speed, laser-based process is one of the possible replacements for the galvanic process. If adopted, it is a very large opportunity for the laser industry.

The laser-based tools (i.e., end user workstations) are a key part of our overall market strategy for materials processing. We enjoyed a good year in medical device manufacturing and believe the regulatory requirement for unique device identification, which goes into effect in September 2018, will drive higher demand for lasers and marking systems capable of producing corrosion free marks in stainless steel. Consumer electronics manufacturing is another active area, especially for ultrafast lasers, subsystems and systems due to the unique capabilities they provide.

We had record orders in the OEM instrumentation market in fiscal 2017 and the outlook is positive. The market is simultaneously addressing greater global access to healthcare, a higher incident rate of age-related conditions and managing costs. Lasers support increased accuracy and efficiency in medical diagnostics and therapeutic treatments that are less invasive with shorter recovery times.

Bioinstrumentation orders reflected our leading position in cytometry as well as a growing business in gene sequencing. Within the medical OEM, bookings were solid across all applications. We are very encouraged by demand trends in dental, surgical consumables and aesthetics. There was substantial annual bookings growth of more than 2X in aerospace and defense. The defense industry is working to address asymmetric threats posed to military personnel, vehicles and vessels. One example is drones that can be easily purchased from electronics distributors and repurposed to deliver IEDs. Directed-energy weapons are one possible solution to counter such a threat. We supply components and lasers to prime and subcontractors that are developing countermeasures. Orders for ground and space-based imaging were also good. We supply the primary collector optics for satellites and telescopes from the same facility that makes the optics for the Linebeam 1500 FPD annealing systems.

The scientific market is largely unchanged. Revenue trends in North America, Europe and Asia are stable. Competitive dynamics exhibit the usual give and take. With the growth that we have experienced in commercial markets, the scientific market now represents well less than 10% of total revenue. We remain committed to our customers in this space and will continue to innovate in support of scientific discovery. Future commentary will be limited to major changes in the market or new technology introductions.

We are very well-positioned for another record-setting year in fiscal 2018. We have a plethora of new products in the pipeline and look forward to expanding our presence in the commercial markets. We have done a very good job of driving profitability and cash generation. We expanded on both in the current fiscal year and plan to use the cash to invest in future growth and retire the debt.

I'll now turn the call over to Kevin Palatnik, our Chief Financial Officer.

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Kevin Palatnik, Executive Vice President and Chief Financial Officer

Thanks, John.

Today, I'll first summarize fiscal fourth quarter 2017 financial results then move to the outlook for fiscal Q1 of 2018. I'll discuss primarily non-GAAP financial results and ask that you refer to today's press release for a detailed description of our GAAP results, as well as a reconciliation between GAAP and non-GAAP financial results. The non-GAAP adjustments relate to stock-based compensation expense, amortization of intangible assets, restructuring costs, impairment of assets held for sale and the related tax adjustments. The full text of today's prepared remarks and trended GAAP and non-GAAP supplemental financial information will be posted on the Coherent Investor Relations website. A replay of this webcast will also be made available for approximately 90 days following the call.

Highlights of the Quarter

Fiscal fourth quarter 2017 financial results for the company's key operating metrics were:

- Total Revenue of $490.3 million dollars,
- Non-GAAP Gross Margin of 48.7%,
- Non-GAAP Operating Margin of 28.8%,
- Adjusted EBITDA of 31.5%, and
- Non-GAAP EPS of $3.72

Sales

Net sales for fiscal fourth quarter were $490.3 million dollars, an increase of $26 million dollars or approximately 6% sequentially and 97% year over year. Sales came in above the high end of the previously guided range, with sales into the Microelectronics and Materials Processing markets providing the largest contributions.

Our revenue mix by market for Q4'17 was Microelectronics at 54.2%, Materials Processing 30.0%, OEM Components and Instrumentation 10.5% and Scientific & Government 5.3%. Geographically, Asia accounted for 64% of revenues in the fiscal fourth quarter, the US 15%, Europe 18% and rest of the world 3%. Asia includes three territories with revenues greater than 10% of total sales.

Other product and service revenues for the fiscal fourth quarter of 2017 were $126 million dollars or approximately 26% of sales representing an increase of approximately 5% sequentially and 79% year over year. Other product revenue consists of spare parts, related accessories and other consumable products and was 23% of sales. Revenue from services and service agreements was approximately 3% of sales.

Total backlog was approximately $1.3 billion dollars at the end of fiscal Q4 2017. The shippable backlog, defined as shippable within the next twelve months, is $1.04 billion. This includes $614 million or approximately 59% of shippable backlog related to flat panel display applications.

We had one customer in South Korea, related to large flat panel display manufacturing, that contributed more than 10% of the company's fiscal fourth quarter revenues.

Gross Profit, Gross Margin, Operating Margin, EBITDA

Fiscal fourth quarter non-GAAP gross profit, excluding stock-based compensation costs, intangibles amortization, purchase accounting and restructuring was $238.8 million dollars. At 48.7% of sales for the quarter, non-GAAP Gross Margin came in virtually at the midpoint of the guided range.

Non-GAAP Operating Margin was 28.8% for the fiscal fourth quarter and was above the midpoint of the guided range as a result of flow through from higher than expected revenues. Adjusted EBITDA was 31.5% in fiscal Q4.

Balance Sheet

Turning to the balance sheet, non-restricted cash, cash equivalents and short term investments were approx. $476 million dollars at the end of fiscal Q4, an increase of approximately $3 million compared to the end of last quarter. During the quarter, cash from Operations generated $100 million dollars and consistent with our priority of using excess cash flow to de-lever the balance sheet, we made a voluntary 75M Euro payment against our outstanding debt.

International cash was $300 million dollars or approximately 63% of the total cash and short term investment balance. Approximately 45% of the total cash and short term investments is denominated in dollars.

Accounts receivable DSO was 56 days, compared to 54 days in the prior quarter.

The net inventory balance at the end of the fourth quarter was approximately $415 million dollars, an increase of $12 million primarily due to f/x.

And Capital spending for the quarter was approximately $18 million dollars or 3.8% of sales.

Fiscal First quarter 2018 guidance

Now, I'll turn to our outlook for our first fiscal quarter of 2018.

Revenue for fiscal Q1 is expected to be in the range of $460 to $480 million dollars. This range reflects the expected seasonality of the legacy Rofin business partially mitigated by the growth in other businesses.

We expect fiscal Q1 non-GAAP Gross Margin to be in the range of 47% to 50%. Non-GAAP gross margin excludes intangibles amortization of approximately $12.2 million dollars and stock compensation costs estimated at $900K.

Non-GAAP Operating Margin for fiscal Q1 is expected to be in the range of 27% to 30%. This excludes intangibles amortization estimated at a total of $14.8 million dollars and stock compensation expense of a total of approximately $7.1 million dollars.

Other income and expense is estimated to be an expense in the range of $7.5 to $8.5 million dollars. We do not include transaction gains and losses related to future changes in foreign exchange rates in our outlook.

We expect our non-GAAP tax rate for fiscal Q1, to be in the range of 30% - 32%.

And, finally, we are assuming weighted average outstanding shares of approximately 25.1 million for the first quarter.

With regard to our participation at upcoming conferences, we'll be presenting at the Stifel Growth Conference on November 9th in Chicago, the Barclays Global TMT conference in San Francisco on December 7th, and the Needham Growth Conference on January 17th in New York.

I'll now turn the call back over to the operator for a Q&A session.