Conference Call Prepared Remarks Q3'18

Bret DiMarco – EVP, General Counsel and Corporate Secretary

Thank you and good afternoon everyone. Welcome to today's conference call to discuss Coherent's results from its third quarter of fiscal 2018.

On the call with me are 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 results, business trends and the expected timing and benefits, if any, of such trends. These forward looking statements may contain such words as "project," "outlook," "future," "expects," "will," "anticipates," "intends" or referred to as "guidance." 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.

These forward looking statements are only predictions and are subject to substantial risks, uncertainties and assumptions that are difficult to predict and may cause actual results, performance or achievement to materially differ from those expressed or implied by these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to: risks associated with global demand for our products, customer acceptance and adoption of our products, the worldwide demand for flat panel displays and adoption of OLED for mobile displays, the demand for and use of our products in commercial applications, our and our customers' exposure to risks associated with worldwide economic conditions, our customers' ability to cancel long-term purchase orders, the ability of our customers to accurately forecast their own end markets and our ability to accurately forecast future periods.

For a detailed description of these and other risks and uncertainties which could impact these forward looking statements, you should review Coherent's periodic SEC filings including its most recent Form 10-K, Form 10-Q and Forms 8-K, including the risks identified in today's financial press release.

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

John Ambroseo – President and Chief Financial Officer

Thanks, Bret. I'd like to welcome everyone to our third fiscal quarter conference call. Before discussing the most recent quarter, I'd like to offer our views on the flat panel display industry, the opportunity within materials processing and a first glimpse of fiscal 2019.

From our vantage point, there is no OLED demand problem. Handset manufacturers would prefer the performance advantages and design flexibility provided by flexible OLED display, but availability and pricing is constraining market proliferation. Panel manufacturers other than Samsung are working to master evaporative deposition and encapsulation. Capabilities around TFT annealing are sufficient at the current time, but will require refinement once the other processes are mastered.

Recent conversations with panel manufacturers about the investment outlook again confirmed that more than twenty OLED fabs are planned between now and 2023. Mobile displays are expected to dominate investments into 2021. For our actual and projected OLED revenue, fiscal 2018 is the current peak and fiscal 2019 will likely be down 15-20% before a recovery starts in fiscal 2020. Systems and service are included in these projections.

We expect most of the new fabs will install Gen 6 hardware. The customer base will be much more diverse than the first phase of buildout that was driven by a single, large customer. The modest investments that we made in optics and testing capacity allows us to ramp quickly and reduce Linebeam 1500 lead times to approximately six months versus the 15-18 month lead times during the first phase of LB1500 production.

We have continued to make inroads into the materials processing market, which was one of the motivations behind the Rofin-Sinar acquisition. The two largest opportunities are in fiber lasers and components for cutting and welding and in laser-based tools for electronics, automotive and medical device manufacturing. Fiber lasers and components will account for roughly $250 million in fiscal 2018 sales and, based upon current forecasts, are poised to grow by more than 20% in fiscal 2019. On the tools side, we have been realigning and augmenting the portfolio to address high-growth opportunities, while de-emphasizing one-off, custom tools. We are especially pleased with the level of customer interest in OR Laser, our recent acquisition in the additive manufacturing space. We believe this business will deliver attractive long-term growth.

Distilling this down, our current expectation for fiscal 2019 is that growth in other markets will largely offset FPD headwinds. We project fiscal 2019 revenue to be within five percentage points of fiscal 2018 sales.

FPD fab utilization improved in the June quarter in support of new handset launches. This was consistent with prior projections, but did not translate into a corresponding increase in FPD service revenue due to customers burning off service spares in a cash management move.

Our semiconductor capex business continues to perform at record highs. Market drivers are unchanged. Investments in advanced nodes, domestic spending in China, automotive and IoT have offset slower spending on memory. The trends are projected to hold into 2019. EUV also appears to be improving, but the very limited number of inspection tools will probably utilize plasma-based EUV sources rather than lasers.

The long-awaited roll out of 5G networks has begun in select test cities, so it’s a good time to review the opportunity for the laser industry. The deployment can be broken into two phases for transmission frequencies below and above 6GHz. The initial, below 6GHz phase, will use technology similar to what's available in 5GHz home Wi-Fi networks. In 2-3 years, the second phase above 6GHz kicks in and various technology changes are necessary including an increase in PCB layers, glass substrates and thinner copper. Collectively, they will drive significant changes in manufacturing beyond today's CO_2-centric infrastructure. We expect solid-state UV and ultrafast lasers to play a more important role in manufacturing.

Materials processing orders were lower following a record-setting second quarter. Revenues and orders from automotive applications posted double-digit growth for battery-related orders. Orders for medical device manufacturing workstations for stent production and marking systems for product identification and traceability were also up. Component orders were slightly lower on the heels of a record performance in Q2. The quarter-to-quarter fluctuation notwithstanding, the appetite for fiber laser components in China remains healthy as Chinese domestic fiber laser manufacturers put up impressive growth numbers. Orders from consumer goods applications were also lower partly due to late qualification starts for certain consumer product cycles.

OEM instrumentation and components bookings hit an all-time high with a book-to-bill well above one. Bioinstrumentation orders were very strong due to multiple, large OEM orders as well as good organic growth from several smaller accounts. Flow cytometry and sequencing applications were the strongest contributors. Record orders from aerospace and defense have doubled over the past year. We have seen a sizeable uptick in defense spending for directed-energy programs and we have won a number of contracts for satellite optics. Our U.S.-based R&D and manufacturing footprint put us in a great position for future wins. Medical OEM orders increased modestly from the usual user group in ophthalmic, dental and aesthetic procedures as well as surgical consumables.

So just to recap:

1. We believe the long-term opportunity in OLED is largely unchanged
2. Based upon current input from customers, FPD revenue will likely be V-shaped from fiscal 2018 to fiscal 2020
3. Our diversity will help temper FPD headwinds as growth in other markets will largely offset the FPD revenue delta in fiscal 2019
4. There are exciting opportunities in electromobility and advanced manufacturing that will contribute to long-term growth

I'd also like to confirm that we completed the repurchase of $100 million of Coherent's common stock in the June quarter. We will continue to deploy cash to drive long-term shareholder returns through accretive acquisitions, share repurchases or debt retirement.

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

<u>Kevin Palatnik – EVP & Chief Financial Officer</u>

Thanks, John.

Today, I'll first summarize fiscal third quarter 2018 financial results then move to the outlook for fiscal Q4. 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, acquisition costs, purchase accounting adjustments, impairment charges (recoveries) 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.

<u>Highlights of the Quarter</u>

Fiscal third quarter 2018 financial results for the company's key operating metrics were:

- Total Revenue of $482.3 million dollars,

- Non-GAAP Gross Margin of 46.4%,
- Non-GAAP Operating Margin of 26.3%,
- Adjusted EBITDA of 29.1%, and
- Non-GAAP EPS of $3.51

Sales
Net sales for fiscal third quarter were $482.3 million dollars, representing growth of approximately 4% year over year. Sales came in at the low-end of our previously guided range primarily as a result of service revenues not ramping as fast as expected.
Our revenue mix by market for Q3 was Microelectronics approximately 54%, Materials Processing 28%, OEM Components and Instrumentation 11% and Scientific & Government 7%. Microelectronics sequential sales growth was virtually flat while Materials Processing declined by approximately 2%. While we're not satisfied with this result, the HP Fiber Laser, within this end market, achieved sequential growth of approximately 17%.

Geographically, Asia accounted for approximately 63% of revenues in the fiscal third quarter, the US 16%, Europe 18% and rest of the world 3%. Asia includes two territories with revenues greater than 10% of total sales.
Other product and service revenues for the fiscal third quarter of 2018 were $121 million dollars or approximately 25% of sales. Other product revenue consists of spare parts, related accessories and other consumable products and was approximately 22% of sales. Revenue from services and service agreements was approximately 3% of sales. Total service revenues were virtually flat year over year as the service utilization decrease in existing field systems offset the service utilization of new systems.

We had one customer in South Korea, related to large flat panel display manufacturing, that contributed more than 10% of our fiscal third quarter revenues.

Gross Profit, Gross Margin, Operating Margin, EBITDA
Fiscal third quarter non-GAAP gross profit, excluding stock-based compensation costs, intangibles amortization, purchase accounting adjustments and restructuring was $224 million dollars. At 46.4% of sales for the quarter, non-GAAP Gross Margin came in at the low-end of the previously guided range. This was primarily related to a one-time warranty expense at the very end of the quarter.
Non-GAAP Operating Margin was 26.3% for the fiscal third quarter and was slightly below the midpoint of the guided range. Operating expenses decreased approximately $6.3 million, of which, the weakness in the Euro contributed approximately $700K.
Adjusted EBITDA was 29.1% in fiscal Q3.

Balance Sheet
Turning to the balance sheet, non-restricted cash, cash equivalents and short term

investments were approximately $232 million dollars at the end of fiscal Q3, a decrease of approximately $114 million compared to the end of last quarter. During the quarter, we repurchased shares in the amount of the total repurchase authorization of $100 million dollars. We did not make a voluntary payment against our term loan debt. The amount of outstanding term loan debt in USD is 434 million dollars.
International cash was $158 million dollars or approximately 68% of the total cash and short term investment balance. Approximately 39% of the total cash and short term investments is denominated in dollars.
Accounts receivable DSO was 63 days, compared to 59 days in the prior quarter.
The net inventory balance at the end of the fiscal third quarter was approximately $495 million dollars, an increase of $2 million, from the prior quarter.
And capital spending for the quarter was approximately $21 million dollars or 4.4% of sales.

Fiscal Fourth quarter 2018 guidance

Now, I'll turn to our outlook for our fourth fiscal quarter of 2018.
Revenue for fiscal Q4 is expected to be in the range of $465 to $485 million dollars.
We expect fiscal Q4 non-GAAP Gross Margin to be in the range of 46% to 49%. Non-GAAP gross margin excludes intangibles amortization of approximately $12.5 million dollars and stock compensation costs estimated at $1.2 million dollars.
Non-GAAP Operating Margin for fiscal Q4 is expected to be in the range of 25% to 28%. This excludes intangibles amortization estimated at a total of $15.1 million dollars and stock compensation expense of a total of approximately $8.6 million dollars.

Other income and expense is estimated to be an expense in the range of $6 to $7 million dollars. We do not include transaction gains and losses related to future changes in foreign exchange rates in our OI&E outlook.

We expect our fiscal Q4 non-GAAP tax rate to be in the range of 27% - 28%.

And, finally, given the share repurchases made in the quarter, we are assuming weighted average outstanding shares of approximately 24.5 million for the fourth quarter.

With regard to our participation at upcoming conferences, we'll be presenting at the Needham Industrial Technologies Conference on August 2nd in New York and Oppenheimer's Midwest Corporate Access Day in Chicago on August 15th.

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