Conference Call Prepared Remarks Q1'19

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 first quarter of fiscal year 2019.

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," "believes," "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, acceptance and adoption of our products, the worldwide demand for flat panel displays and adoption of OLED for mobile displays, the pricing and availability of OLED displays, the demand for and use of our products in commercial applications, our ability to generate sufficient cash to fund capital spending, operations or debt repayment, our successful implementation of our customer design wins, our ability to successfully rectify execution issues on a going forward basis, our and our customers' exposure to risks associated with worldwide economic conditions, particularly China, our customers' ability to cancel long-term purchase orders, the ability of our customers to accurately forecast their own end markets, our ability to accurately forecast future periods, continued timely availability of products and materials from our suppliers, our ability to timely ship our products and our customers' ability to accept such shipments, our ability to have our customers qualify our products, worldwide government economic policies, including trade relations between the U.S. and China and China monetary policies, our ability to integrate the business of Rofin and other acquisitions successfully, manage and integrate our expanded operations and achieve anticipated synergies, and other risks identified in the Company's SEC filings.

For a detailed description of 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.

<u>John Ambroseo – President and Chief Executive Officer</u>

Thanks, Bret. Good afternoon everyone.

We are currently experiencing a diverse set of market conditions. The materials processing market in China is facing increasing pressure due to a number of factors. The business outside of China is a different story. The flat panel display business is in-line with industry expectations. The trends in semi, API and instrumentation are generally positive. We are adjusting our customer engagement and investments accordingly.

Against a challenging backdrop, overall microelectronics bookings posted low double-digit, sequential growth. Several factors contributed to this result. While general semicap spending is slowing, fab utilization remains high, which translated into very strong service renewals. This included leading edge nodes for high-performance logic and memory production as well as legacy nodes for IoT and automotive devices. Some of the lasers used in legacy nodes have either reached end of life or are very difficult to support due to a lack of parts. In anticipation of this, we developed several solid-state alternatives that dramatically reduce utility costs due to a thousand-fold increase in electrical efficiency. Demand for these replacement units has been understandably good. The API market experienced even higher sequential growth, signaling that the oversupply in microvia is ebbing. Orders also rose for PCB cutting and redistribution layer structuring. The final contribution came from the solar market. We booked a record order for ultrafast lasers used in thin film scribing against an incumbent supplier. The end customer anticipates to further expand capacity over the next four quarters.

The FPD market can best be characterized by its constancy and continuous innovation. Samsung continues to dominant the mobile display market with roughly a dozen other firms trying to close the gap. We recently surveyed the chase group regarding their R&D commitments and projected timing for future investments. There appears to be little to no change in appetite or desire. Timing is subject to improvement in manufacturing yields and funding, whether from the government or handset manufacturers. With a fair amount of future investment coming from China, we have been inquiring whether the country's economic slowdown will affect government support of display manufacturers. The answers vary, but most believe the funding will be available when they need it.

During last quarter's earnings call, I mentioned that we were negotiating the cancellation of an ELA order. We reached resolution with the customer during our fiscal Q1. While the overall ongoing business framework is confidential, we can disclose that a one-time $7 million upfront fee is included in our first fiscal quarter results. The balance of the business considerations will be recognized over time and will be incorporated into our quarterly guidance.

The Korean government has been closely watching the investment and advancement in OLED technology by Chinese display companies. It is probably particularly frustrating that some of technology developments have been aided by Korean ex-pats employed by Chinese competitors. As a result, we understand that the Korean government is considering designating the Korean OLED equipment industry as a core technology of Korea. If this happens, it would restrict Chinese manufacturers' abilities to purchase Korean equipment or invest in Korean equipment companies. There are certain techniques, like lamination, where Korean vendors have a leadership position. Much of the other equipment in an OLED fab can be sourced outside Korea, so an embargo might slow, but would not ultimately stop, Chinese display manufacturers.

FPD service demand has been stable for the past two quarters, even though customers have reduced their service inventories. This would suggest utilization rates have been good.

There were a large number of OLED-equipped devices on display at CES this year ranging from tablets to rollable TVs. Mobile computing displays represent an interesting opportunity for the industry since they consume a total surface area similar to the handset market. Some of the companies exhibiting these devices include Samsung, HP, Dell, Asus and Lenovo. Shipments should commence in the next few months. If consumer adoption is strong, OLED capacity will likely have to be added to support surface area growth. OLED and 8k TVs were also in abundance at CES. The most impressive demo was rollable OLED TVs from LG, which won numerous awards. Availability of rollable units may come later this year with a price tag that could exceed $20k. MicroLEDs also made an appearance, predominantly in very large formats up to 219” based upon an 8x8 inch tile architecture. The image quality was impressive as was the size. When commercially available, these displays would be ideal for cinemas and signage. A microLED TV was on display in the Samsung booth. It was 75” and had 4k resolution. Apparently, you could own one for the price of an average single-family home.

The strong bookings trend in instrumentation and OEM components continued in Q1. Bioinstrumentation customers are seeing solid demand from key applications like cytometry and cite double-digit growth in emerging markets as one of the reasons. Light engines, a combination of lasers and wavelength-switchable delivery systems, represent an increasing amount of our bioinstrumentation business. Customers can exploit the capabilities of and appreciate the reliability and ease of integration of our light engines, leading a major player to recognize us with their annual innovation award.

Medical OEM customers are also enjoying favorable conditions. Orders were up for dental and urology products. Demand was stable for aesthetic and ophthalmic lasers. Stable demand in aesthetic is particularly encouraging since it relies on discretionary consumer spending and can be seen as a loose proxy for consumer confidence in the Americas and Europe.

Orders for aerospace and defense applications grew by 45% year-over-year. The largest contributions came from US-based, directed energy projects and space-based telescope applications. The activity in both areas is on the rise and we are well-positioned as a U.S.-based manufacturer.

It was a predictably challenging quarter for the materials processing business as the combination of tariffs, rising Chinese consumer debt and eroding Chinese consumer confidence and spending have taken a toll on the Chinese economy. The Chinese government has to strike a delicate balance between reining in debt and providing stimulus, which has been previously effective in driving demand for big-ticket items like autos and appliances. In addition to these macro factors, a price war in certain fiber lasers continues to further exacerbate the challenges for the laser industry in China. There are some bright spots, however. Our focus on automotive applications is yielding results. We received significant orders for electromobility projects in Asia and Europe. The automotive market continues to perform well and we expect bookings to grow for battery, powertrain and body-in-white projects over the remainder of FY19. We were also pleased by a bookings increase in medical device manufacturing including a record 10% contribution from China. The Chinese medical device industry is expected to grow by as much as 25%, so this may provide a partial offset to the broader Chinese materials processing market.

The question on everyone's mind is what will 2019 look like? The risk associated with China has increased over the past quarter as we've learned more about the evolving underlying situation, particularly their domestic challenges. Based upon these and other factors, it would be understandable to have a more dour outlook. On the opposite side of the ledger, there are a number of things that could happen, any one of which could send markets upward. For example, we could have an end to the trade conflict leading to improved consumer confidence. The Chinese government could institute a stimulus package that encourages investment and/or consumption without piling on debt. Someone other than Samsung could make a breakthrough in OLED yields, which accelerates investment in new capacity. Some of these are more likely than others. All would have a marked impact. And all contribute to the uncertainty regarding the outlook for 2019, which makes full-year forecasting very difficult and, as a result, we are not issuing full fiscal year guidance. We will focus on quarterly forecasting for the foreseeable future.

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

Kevin Palatnik – EVP & Chief Financial Officer

Thanks, John.

Today, I'll first summarize fiscal first quarter 2019 financial results then move to the outlook for fiscal Q2. 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, purchase accounting adjustments, the related tax adjustments and tax adjustments for stock based compensation. 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 first quarter 2019 financial results for the company's key operating metrics were:

- Total Revenue of $383.1 million dollars,
- Non-GAAP Gross Margin of 42.6%,

- Non-GAAP Operating Margin of 20.0%,
- Adjusted EBITDA of 23.1%, and
- Non-GAAP EPS of $2.09

Sales

Total revenue for the fiscal first quarter was $383.1 million dollars. As expected, Microelectronics and Materials Processing sales decreased sequentially by approximately $66 and $20 million dollars, respectively, primarily due to lower Excimer shipments into the FPD market and decreased shipments of tools and diode components in the materials processing market.

Our revenue mix by market for Q1 was Microelectronics approximately 47%, Materials Processing 27%, OEM Components and Instrumentation 17% and Scientific & Government 9%. Geographically, Asia accounted for approximately 55% of revenues in the fiscal first quarter, the US 22%, Europe 19% and rest of the world 4%. Asia includes two territories with revenues greater than 10% of total sales.

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

Other product and service revenues for the fiscal first quarter of 2019 were $118 million dollars or approximately 31% of total sales. Other product revenue consists of spare parts, related accessories and other consumable products and was approximately 28% of sales. Revenue from services and service agreements was approximately 3% of sales. Total service revenues were sequentially flat as our key integrators continue to focus on conserving cash by keeping their service stock to lower threshold amounts.

Gross Profit, Gross Margin, Operating Margin, Adjusted EBITDA

Fiscal first quarter non-GAAP gross profit, excluding stock-based compensation costs, intangibles amortization, restructuring and purchase accounting was $163 million dollars. Non-GAAP gross profit was impacted sequentially by volumes, product mix and warranty costs, partially offset by the one-time cancellation fee, resulting in non-GAAP gross margin of 42.6% for Q1.

Non-GAAP Operating expenses decreased by approximately $10 million dollars primarily due to deferred compensation liability decreases as well as the increased number of holidays and vacation taken in December, the end of our fiscal Q1. While we experienced a significant operating expense decrease sequentially, it was not enough to offset lower non-GAAP gross profit, resulting in a non-GAAP operating margin of 20.0% for the fiscal first quarter. Adjusted EBITDA was 23.1% in fiscal Q1.

Balance Sheet

Turning to the balance sheet, non-restricted cash, cash equivalents and short term investments were approximately $320 million dollars at the end of fiscal Q1, an increase of approximately $9 million compared to the end of last quarter.

During the quarter, we repurchased shares totaling approximately $25M dollars and borrowed $40M dollars against our line of credit. We did not make any voluntary payments against our term loan. The outstanding amount of the term loan, in USD, is approximately $422 million dollars.

International cash was $219 million dollars or approximately 68% of the total cash and short term investment balance. Approximately 37% of the total cash and short term investments is denominated in dollars.

Accounts receivable DSO was 78 days, compared to 69 days in the prior quarter. The increase related to large collections that occurred in January 2019 rather than in December 2018.

The net inventory balance at the end of the fiscal first quarter was approximately $493 million dollars, an increase of $6 million, from the prior quarter. And capital spending for the quarter was approximately $23 million dollars or 6% of sales.

<u>Fiscal second quarter 2019 guidance</u>

Now, I'll turn to our outlook for our second fiscal quarter of 2019.

Revenue for fiscal Q2 is expected to be in the range of $360 to $380 million dollars.

We expect fiscal Q2 non-GAAP Gross Margin to be in the range of 37.5% to 40.5%.

Non-GAAP gross margin excludes intangibles amortization of approximately $12.5 million dollars and stock compensation costs estimated at $1.3 million dollars.

Non-GAAP Operating Margin for fiscal Q2 is expected to be in the range of 12.5% to 15.5%. This excludes intangibles amortization estimated at a total of $15.1 million dollars and stock compensation expense of a total of approximately $8.7 million dollars.

Other income and expense is estimated to be an expense in the range of $5 to $6 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 Q2 non-GAAP tax rate to be in the range of 25% - 26%.

And, finally, we are assuming weighted average outstanding shares of approximately 24.5 million for the fiscal second quarter.

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