Conference Call Prepared Remarks Q4'18 and Year-End Results

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 fourth quarter and fiscal year 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," "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, 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, 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, worldwide government economic policies, including U.S. tariffs on Chinese manufactured goods, our ability to integrate the business of Rofin and other acquisitions successfully, our ability to 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.

John Ambroseo – President and Chief Executive Officer

Thanks, Bret. Good afternoon everyone. I have a lot of information to communicate today and I'll start with our disappointing fourth quarter results, which were impacted by execution errors at one of our German manufacturing sites and a pronounced weakening of Chinese market conditions.

Part of the integration of legacy Rofin sites is an ERP implementation. For those of you who have experienced one, you know they're complex, painful and not very much fun. We have already successfully completed a number of these across Europe and Asia. The site undergoing an implementation in the September quarter had particularly complex legacy practices that did not translate well. Gaps are normally identified through testing, but were not caught in this case either due to inexperience, lack of judgment or resistance to change. These gaps caused a manufacturing parts shortage late in the quarter that stranded millions of dollars of shippable inventory and required us to push new rather than refurbished material out for service. Kevin will review the specific financial impact of this during his remarks. We have taken various remedial actions to correct the situation including changes in processes, responsibilities and personnel. We anticipate having these remedies completed within the current quarter.

Market conditions in China began to noticeably erode around the middle of August as Chinese manufacturers came to grips with U.S. tariffs on Chinese goods. The drop in export demand caused many Chinese customers to re-evaluate their expansion plans, leading them to push out or, in some limited cases, cancel orders. The effect was mostly confined to the materials processing space that covers the manufacture of soft and durable goods. Business in China was also affected by retaliatory tariffs on a range of US goods including certain photonic products. While the tariff percentage was high, the cost increase against the customers' bill of materials was far from debilitating. To complete the picture, the first salvos in an apparent price war in the 1-4 kilowatt fiber laser space further exacerbated the challenges in the materials processing market. Customers claimed prices have been discounted up to 30% within the September quarter. While pricing may be more about market share than end user demand, it forces greater discipline about what business to pursue.

There have been a number of notable developments and announcements in the flat panel industry. Fab utilization rates have risen with the release of two new OLED-equipped iPhones®. This has had a favorable impact on LDU service demand. Several recent reports support continued investment in China and, building on what we reported on our last call, a broader recovery in 2020 including AU Optronics converting an LCD fab into a flexible OLED facility as reported in Digitimes, Visionox announcing a $6.3 billion investment in a second Gen6 flexible OLED line according to OLED Info, DSCC and CINNO noting Taiwan-based Kuntech's cooperation with the local government on a new Gen6 flexible

OLED fab in Shanxi and the Korean government establishing an OLED R&D center with $470 million of funding. There have also been recent announcements from Samsung and LG regarding foldable displays for mobile computing. Samsung is seeking to bring “new value to the user experience” in its own laptops. LG is said to be partnering with Lenovo on a 13-inch foldable tablet.

While the trends continue to point to a 2020 recovery, there are some near-term issues that we have to deal with in the display space. A customer has requested we postpone a shipment scheduled for this quarter into early next quarter. We have agreed to accommodate this request, resulting in approximately $10 million of revenue moving from our first to second fiscal quarter. Another customer had scheduled deliveries for two Linebeam 1000’s this quarter and some unscheduled backlog. The customer did not win as much business for flexible OLEDs as they had imagined and does not have an immediate need for additional equipment. They have proposed paying us compensation in lieu of taking these deliveries. We anticipate reaching an amicable settlement to resolve this situation.

Customers have expressed a reasonable amount of interest in our microLED solutions. We are taking orders for R&D tools. If the research efforts are successful, a market release of cost-effective, mass production displays is still years away.

I have previously commented that the outlook for semicap was easing and a decline in memory spending could be offset by sovereign investment in the

Chinese chip industry. Memory prices decreased by 10% in the September quarter and, based upon industry reports, are projected to shed another 10-15% in the December quarter. This inevitably leads to a slowdown in capex investments, although fab utilization and the corresponding service revenue remains high. The trade war between the US and China has slowed Chinese semicap investment either through direct tariff impact, retribution or funding uncertainty. The net effect points to total 2019 semicap spending being down versus 2018.

The API market is running at a consistent level. Multiple competitors to microvia market leader Mitsubishi have positioned themselves to take share, which we believe will benefit us since we supply the laser sources. Fan-out wafer level packaging continues to grow, especially in support of 5G deployment. This should drive demands for our laser direct imaging sources.

Our component and instrumentation business delivered another record bookings performance in the fourth fiscal quarter. Bioinstrumentation orders were seasonally strong with contributions from cytometry and sequencing. Orders from medical OEM accounts were up significantly on a sequential basis and compared to the prior year period. All applications -ophthalmic, dental, aesthetic and surgical consumables – did very well. Aerospace and defense was down after a record third quarter result, but the outlook remains very positive.

We recently completed two small acquisitions. In the first, we purchased Ondax, an LA-based company that makes frequency-stabilizers used in high-power laser diodes. They are critical components for defense and solid-state pumping applications used in Coherent products and sold to others in the industry. Ondax also uses these devices in their own line of bioinstrumentation lasers. We also acquired certain intellectual property and equipment from the aerospace and laser coatings business of Quantum Coatings, which is highly complementary to our aerospace and FPD optics business. Quantum has been the world's premier supplier of space-qualified metal coatings. Coherent and Quantum have jointly supported multiple deployments including the polishing and coating of optics for the James Webb Space Telescope, which will look for first light after the Big Bang when it launches in 2021. The same core technology is applied to our Linebeam optics for FPD such that we are vertically integrated on a go-forward basis. Both transactions were done with cash and are immediately accretive.

As I mentioned earlier in my prepared remarks, we have implemented remedies to resolve the short-term operational issues. Market conditions, especially in China, are harder to predict. While we are well positioned across our verticals for multiple outcomes, we think it prudent to update our 2019 revenue outlook. We are now forecasting fiscal 2019 to be down 8-12% compared to fiscal 2018 actuals. We believe the second half will be stronger than the first half. Given the updated forecast, we are taking steps to reduce our burn rate by $10-15 million compared to fiscal 2018. The reductions come from a variety of sources including headcount, program spending and marketing. Our balance sheet and cash generation remains very solid. We will continue to pursue complementary acquisition opportunities. We have also received board authorization to repurchase up to $250 million in the company's common stock over the next year with a limit of no more than $75 million deployed in any given quarter.

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 fourth quarter 2018 financial results then move to the outlook for fiscal Q1 2019. 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), the related tax adjustments and tax adjustments primarily for the U.S. Tax Cuts and Jobs Act. 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 2018 financial results for the company's key operating metrics were:

- Total Revenue of $461.5 million dollars,
- Non-GAAP Gross Margin of 44.1%,
- Non-GAAP Operating Margin of 23.1%,
- Adjusted EBITDA of 26.7%, and
- Non-GAAP EPS of $3.22

Sales

As John mentioned in his prepared remarks, the company experienced a manufacturing parts shortage that impacted the second half of fiscal fourth quarter sales by approximately 6 million dollars. In addition, as Chinese market conditions eroded during the second half of the quarter, customer pushouts and a few cancellations impacted Q4 by approximately 5 million dollars. These impacts, along with lower volumes in other end markets, resulted in net sales for the fiscal fourth quarter of $461.5 million dollars.

Our revenue mix by market for Q4 was Microelectronics approximately 53%, Materials Processing 27%, OEM Components and Instrumentation 14% and Scientific & Government 6%. Microelectronics and Materials Processing sales decreased sequentially by approximately $18 and $8 million, respectively, primarily due to lower Excimer and general shipments into the FPD market and decreased shipments of tools used for marking and engraving systems in the materials processing market.

Geographically, Asia accounted for approximately 61% of revenues in the fiscal fourth quarter, the US 18%, 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 2018 were $118 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 decreased sequentially as our key integrators continue to focus on conserving cash by keeping their service stock to lower threshold amounts.

We had two customers in South Korea, related to large flat panel display manufacturing, that each contributed more than 10% of our 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 and restructuring was $204 million dollars. Non-GAAP gross profit was impacted sequentially by both product mix and volumes. In addition, the use of new material rather than refurbished material for warranty repairs impacted non-GAAP gross margin by close to a full point. This resulted in non-GAAP gross margin for Q4 of 44.1%.

While operating expenses decreased by approximately $500K sequentially, it was not enough to offset lower non-GAAP gross profit, resulting in a non-GAAP operating margin of 23.1% for the fiscal fourth quarter. Adjusted EBITDA was 26.7% in fiscal Q4.

Tax

As you know, the U.S. Tax Cuts and Jobs Act was enacted approximately one year ago. The legislation imposed a one-time Transition Tax on foreign subsidiaries earnings and profits, and allowed for a one year measurement period for the impact of this legislation. Coherent reported an estimate of the financial impact of the tax reform in fiscal Q1 2018 and refined those estimates in Q4. This is the primary reason for a lower than expected Q4 non-GAAP tax rate of approximately 22%.

Balance Sheet

Turning to the balance sheet, non-restricted cash, cash equivalents and short term investments were approximately $311 million dollars at the end of fiscal Q4, an increase of approximately $78 million compared to the end of last quarter. The amount of outstanding term loan debt in USD is 431 million dollars. International cash was $216 million dollars or approximately 69% of the total cash and short term investment balance. Approximately 38% of the total cash and short term investments is denominated in dollars.

Accounts receivable DSO was 69 days, compared to 63 days in the prior quarter.

The net inventory balance at the end of the fiscal fourth quarter was approximately $487 million dollars, a decrease of $8 million, from the prior quarter.

And capital spending for the quarter was approximately $25 million dollars or 5.4% of sales.

Fiscal first quarter 2019 guidance

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

As a result of a customer request to postpone a Linebeam shipment out of Q1 and another customer no longer having an immediate need for two Linebeam systems that were planned on being delivered in Q1, revenue for fiscal Q1 is expected to be in the range of $375 to $395 million dollars.

We expect fiscal Q1 non-GAAP Gross Margin to be in the range of 42% to 45%. Non-GAAP gross margin excludes intangibles amortization of approximately $12.4 million dollars and stock compensation costs estimated at $1.3 million dollars. Non-GAAP Operating Margin for fiscal Q1 is expected to be in the range of 17% to 20%. This excludes intangibles amortization estimated at a total of $15 million dollars and stock compensation expense of a total of approximately $8.8 million dollars.

Other income and expense is estimated to be an expense in the range of $4 to $5 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 Q1 non-GAAP tax rate to be in the range of 26% - 28%.

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

With regard to our participation at upcoming conferences, we'll be presenting at the Needham Growth Conference on January 15th in New York.

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