Conference Call Prepared Remarks
Coherent, Inc. Reports First Fiscal Quarter of 2018 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 the first fiscal quarter of 2018.

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 and business trends. 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 Executive Officer

Thanks, Bret. I'd like to welcome everyone to our first fiscal quarter conference call. Our financial results for last quarter were solid in all aspects and Kevin will review them in more detail in just a few minutes. I'll start out by providing our perspective on the display market. Since sales figures for the iPhone X started to leak several weeks ago, assumptions have been rampant regarding the near and long term outlook for OLEDs, leading to very high volatility for related stocks. The operating environment is far less dramatic. A channel check with integrators and panel manufacturers did not identify any changes in delivery cadence or service demand. What's the reason for the disconnect? We think it's rather simple. The leading OLED manufacturer committed its resources to a single customer. Other interested parties, left with no choice, stayed with LCDs. Turning these customers on requires them to change the display drive electronics which takes months not days, so the leading supplier has a short-term glut. Other panel manufacturers continue to invest in technology and capacity as a means to broaden the OLED market and capture share. They have shown no signs of slowing down. The only bump in our road is a short-term, supplier-related issue that Kevin will address in his prepared remarks.

Orders for the semicap market grew well into double digits over the prior quarter on memory demand. The growth was for lasers used in inspection. The industry outlook for the balance of calendar 2018 remains upbeat. Memory prices are projected to soften throughout the year and attention will then shift to the EUV rollout and fab utilization, especially for legacy nodes.

The advanced packaging market was lower following a good Q4. Via drilling is tracking the trend in semicap, particularly for smartphones. Packaging houses are eager to see equipment lead times come down and tool manufacturers are cautiously increasing output. These customers are also evaluating the best pathway to drill smaller vias. The potential solutions include CO and nanosecond UV lasers, which are both part of our portfolio. The other area that has become very active is flex PCBs, again for smartphone applications. Nanosecond UV lasers, such as our Avia™ NX series, are the solution of choice here.

Although the materials processing market exhibited typical seasonality in the December quarter, there were a number of notable highlights. The first quarter book-to-bill was positive. We secured our first volume order from one of the largest integrators in China for sheet metal cutting. The order was for a combination of 3 kilowatt and 6 kilowatt fiber lasers. This is a great first step in a large account. In the overall sheet metal market, more than half of our orders were for lasers above 6 kilowatts, which is following the trends in the market. Integrators and end customers are experiencing the usual growing pains in transitioning to higher powers, but are confident that the power management issues will be resolved.

Orders for automotive applications were up significantly on a sequential basis from several applications. A Tier 1 supplier ordered high-power fiber lasers for fuel injector welding. Polymer welding for body trim and lighting assemblies was up. Bookings for lasers and modules used in label printing and marking were also higher on compliance and traceability requirements.

Medical device manufacturing workstations posted very good results. The driver is an aging population that increasingly requires stents as part of cardiovascular therapy. We have gained share in this area by combining a legacy Rofin workstation with a Coherent laser. Orders for device marking increased significantly where our lasers are used to print product identification information that resists fading and contamination.

Bookings in OEM components and instrumentation were predictably lower after a record-setting fourth quarter. Timing aside, the market is in good shape. Bioinstrumentation is growing based upon increased clinical adoption of flow cytometry or cell sorting and sequencing. We serve these applications with our OBIS™, Sapphire™ and subsystems solutions. Medical OEM customers are anticipating sustained growth above 10% through the early 2020's for aesthetic, surgical and dental applications. The drivers are well understood: less invasive procedures, faster healing and delivering what Ponce de Leon couldn't – the fountain of youth.

By contrast, the ophthalmic market is facing some challenges. Western markets have a significant installed base of vision correction tools. Products are very accurate and the performance enhancements have slowed. To further complicate matters, a series of acquisitions by big pharma over the past few years has not delivered the targeted financial results. These assets are back in play, which contributes to market uncertainty.

The aerospace and defense market is rapidly evolving with several technologies moving from proof principle to deployment. Directed energy devices are being called upon to dazzle, disable or destroy targets in land, sea and air platforms. The timeline calls for low-power dazzlers to deploy in 2019. We are providing components and modules to primes and sub-primes in this area. We continue to secure orders for large optics used in satellites and telescopes that we produce alongside ELA optics in our Richmond facility.

Our outlook for fiscal 2018 is unchanged. We expect it to be a record-setting year. Our integration and expansion plans remain on track. We made another voluntary principal payment of €75 million at the end of December. This brings our total voluntary principal payments to €225 million and we've repaid about a third of the loan in the first twelve months. We anticipate sustained strong cash generation. We will continue to invest in growth and pay down the debt. We also want the flexibility to return value to shareholders. Our board has authorized us to repurchase up to $100 million of common stock over the next twelve months. Any buyback will be subject to customary market conditions and limitations.

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

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Coherent, Inc. Reports First Fiscal Quarter of 2018 Results
Kevin Palatnik, Executive Vice President and Chief Financial Officer

Thanks, John.

Today, I'll first summarize fiscal first quarter 2018 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, impairment of assets held for sale, the related tax adjustments and tax adjustments for the 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 first quarter 2018 financial results for the company's key operating metrics were:

- Total Revenue of $477.6 million dollars,
- Non-GAAP Gross Margin of 48.5%,
- Non-GAAP Operating Margin of 27.8%,
- Adjusted EBITDA of 30.9%, and
- Non-GAAP EPS of $3.54

Sales

Net sales for fiscal first quarter were $477.6 million dollars, representing growth of 38% year over year. As expected, sales came in seasonally weaker in fiscal Q1'18 when compared with fiscal Q4'17, specifically in the Materials Processing market, but overall exceeded the midpoint of our previously guided range.

Our revenue mix by market for Q1'18 was Microelectronics at 56.2%, Materials Processing 26.7%, OEM Components and Instrumentation 10.2% and Scientific & Government 6.9%. Geographically, Asia accounted for 66% of revenues in the fiscal first quarter, the US 15%, Europe 16% 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 first quarter of 2018 were $129 million dollars or approximately 27% of sales representing an increase of approximately 2% sequentially and 57% year over year. Other product revenue consists of spare parts, related accessories and other consumable products and was 24% of sales. Revenue from services and service agreements was approximately 3% of 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.

Gross Profit, Gross Margin, Operating Margin, EBITDA

Fiscal first quarter non-GAAP gross profit, excluding stock-based compensation costs, intangibles amortization and restructuring was $231.5 million dollars. At 48.5% of sales for the quarter, non-GAAP Gross Margin came in at the midpoint of the previously guided range. Non-GAAP Operating Margin was 27.8% for the fiscal first quarter and was below the midpoint of the guided range primarily as a result of the strength of the stock market and its impact on our non-qualified deferred compensation plan liabilities. We record changes in plan liabilities to Cost of Sales and Operating Expenses with a nearly offsetting entry to Other Income and Expense for changes in plan assets. The impact to Non-GAAP Operating Margin was nearly 50 bps, however, the net impact is virtually zero to EPS. Adjusted EBITDA was 30.9% in fiscal Q1.

Tax

With regard to the Tax Cuts and Jobs Act, as expected, we realized a small benefit from the lower tax rates. Our fiscal Q1 proforma tax rate was 28.8%, a decrease from fiscal Q4 2017's proforma tax rate of 29.3%. As a reminder, the significant majority of our profits are generated overseas so the change in tax legislation has a minor effect on our rates.

Balance Sheet

Turning to the balance sheet, non-restricted cash, cash equivalents and short term investments were approx. $423 million dollars at the end of fiscal Q1, a decrease of approximately $52 million compared to the end of last quarter. During the quarter, cash from operations generated $65 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 $273 million dollars or approximately 65% 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 58 days, compared to 56 days in the prior quarter.

The net inventory balance at the end of the first quarter was approximately $433 million dollars, an increase of $18 million due to growth needed to support our Excimer and High Power Fiber Laser businesses.

And Capital spending for the quarter was approximately $24 million dollars or 5.0% of sales.

Fiscal Second quarter 2018 guidance

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

Revenue for fiscal Q2 is expected to be in the range of $470 to $490 million dollars. This range reflects the impact of one of our suppliers being behind on deliveries with a critical component in the manufacture of our linebeam systems. As a result, we expect we will miss a single system shipment in fiscal Q2. Given the ASP of this machine is approximately $10 million dollars, this becomes meaningful to the top line. We are in the process of implementing actions to remediate this issue and expect to be back on track with shipments within a quarter's time.

We expect fiscal Q2 non-GAAP Gross Margin to be in the range of 46% to 49%. Non-GAAP gross margin excludes intangibles amortization of approximately $11.6 million dollars and stock compensation costs estimated at $1.1 million dollars. This range is a sequential decrease to fiscal Q1 results and reflects the continuing strength of the Euro. The FX impact included in this range is approximately 70 basis points.
Non-GAAP Operating Margin for fiscal Q2 is expected to be in the range of 25% to 28%. This excludes intangibles amortization estimated at a total of $14.1 million dollars and stock compensation expense of a total of approximately $8.1 million dollars. This range is also a sequential decrease to fiscal Q1 results and is also impacted primarily by FX. The total FX impact included in the Non-GAAP Operating Margin range is approximately 120 basis points.

Other income and expense is estimated to be an expense in the range of $5.5 to $6.5 million dollars.

We expect our overseas income to increase in fiscal Q2 such that our non-GAAP tax rate is expected to be in the range of 29% - 30%.

And we are assuming weighted average outstanding shares of approximately 25.1 million for the second quarter.
Finally, I would just like to note that historically, we haven't talked much about FX since it didn't have a material impact on our financial results. However, as a result of the Rofin acquisition, we now have a larger population exposed to the Euro. At the current 1.24 rate, the strength of the Euro has a projected 120 bps impact on Operating Margin which translates into an impact of $0.16 to Non-GAAP EPS (Earnings per Share) for fiscal Q2'18.

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