Conference Call Prepared Remarks Q2'19

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 second fiscal quarter.

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 and our customers' exposure to risks associated with worldwide economic conditions, in particular in China and the Eurozone, 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 United States and China and Chinese monetary policies, our ability to integrate the business of Rofin and other acquisitions successfully, manage and integrate our expanded operations and achieve anticipated synergies, as well as, 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.

Our four verticals are very much in-line with global trends. The microelectronics business is experiencing a lull in new capacity additions and utilization rates are currently stable. Materials processing demand is showing its dependence on PMI data as well as effects from trade issues. The components market remains robust, especially within aerospace and defense. In the research market, the U.S. and China are facing off for citation and investment leadership.

The OLED market performance is in-line with our previously announced expectations of a down year for capital spending. Scheduled deliveries are continuing and will likely trough in the current fiscal quarter. Service demand is very consistent with fab utilization data, which we believe is influenced by iPhone® sales. We would expect service revenue to grow if Apple goes all-OLED for this year's product rollout. Overall customer engagement remains very high and RFQ activity is increasing. Based upon historical trends, the conversion of RFQs to orders is typically in the 6-9 month range. If that type of trend holds along with the increased RFQ activity, this would be consistent with a projected capital spending recovery starting in calendar 2020.

There have been numerous reports about yield improvements for display makers not named Samsung. It's difficult to opine on these reports because each manufacturer has its own criteria. The source of the improvements is usually attributed to improved lamination and fine metal mask alignment.

Initial shipments of foldable displays began recently and it has been a bumpy start based upon product reliability. This isn't the first time a new display technology has struggled out of the gate and we assume that failure analysis will lead to a solution. These early issues aside, nearly every display manufacturer has announced a plan around foldable displays with product releases in the 2-3 year time frame.

We believe our semicap business has been outperforming the broader wafer fab equipment market for several reasons. Fab utilization remains high, which supports service revenue. Our lead OEMs have gained market share against their competitors and have also continued to invest in next generation designs. This often drives new system sales. The larger node market is doing well due to demand from IoT and automotive devices. Analysts predict there is a need for 2000 additional tools to serve these applications. Refurbishing older tools can provide partial relief. The established players may not want to build legacy tools, so new vendors are considering the space. We are positioned to address the demand either through legacy devices where copy exact is required or our new generation of energy-efficient solid-state alternatives.

The API market has slowed from last year's run rate, which is reflective of an overall industry trend. Initial orders for specific 5G processes are coming in, but most vendors are taking a wait and see approach until the long-term requirements are better understood.

Materials processing orders improved in the low double-digit range from the previous quarter. We believe part of this can be attributed to seasonality and part to pent up demand. If we look at it on a regional basis, the US continues to perform well with a PMI number above 50. The Eurozone is struggling and Germany's most recent PMI number is at its lowest level since July 2012. There are conflicting signals in the Chinese market. Trade issues with the US and weak domestic demand persist, but the atmosphere at Lasers Shanghai was upbeat, leading some to project a second half rebound in orders. We are taking a more measured view and believe the recovery will be slow and steady.

OEM components and instrumentation continues to be a bright spot. Bookings increased sequentially and compared to the prior year period. Revenue is currently on-track for strong double-digit growth, which could culminate in a record year. The biggest contributor to growth is our aerospace and defense business, which we believe will approximately double compared to FY18. Our leadership positions in bioinstrumentation and medical OEM remain unchallenged. Our customers are seeing growth in emerging markets and new applications. These encouraging trends will further benefit from new products that create even greater value for customers.

I trust that everyone has seen the announcement that I plan to retire no later than April 2021. There's no mystery behind the decision. I'm approaching my 31st anniversary with Coherent and am in my 17th year as CEO. It's time for me to start planning for what's next. The two-year runway is intended to allow ample time for a search and handoff to my successor. Until then, it's business as usual.

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 second quarter 2019 financial results then move to the outlook for fiscal Q3. 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 and restructuring costs, 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 second quarter 2019 financial results for the company's key operating metrics were:

- Total Revenue of $372.9 million dollars,
- Non-GAAP Gross Margin of 38.7%,
- Non-GAAP Operating Margin of 14.2%,
- Adjusted EBITDA of 18.2%, and
- Non-GAAP EPS of $1.61.

Sales

Total revenue for the fiscal second quarter was $372.9 million dollars and came in slightly above the midpoint of our previously guided range.

Our revenue mix by market for Q2 was Microelectronics approximately 45%, Materials

Processing 28%, OEM Components and Instrumentation 18% and Scientific & Government 9%. Geographically, Asia accounted for approximately 51% of revenues in the fiscal second quarter, the US 23%, Europe 22% and rest of the world 4%. Asia includes three territories with revenues greater than 10% of total sales. Europe includes one territory with revenues greater than 10% of total sales.

We had two customers, one in South Korea and one in Japan, related to large flat panel display manufacturing, that each contributed more than 10% of our fiscal second quarter revenues. Other product and service revenues for the fiscal second quarter were $116 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 down by approx. $2 million 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 second quarter non-GAAP gross profit, excluding stock-based compensation costs, intangibles amortization, and restructuring was $144 million dollars. Non-GAAP gross profit was impacted sequentially primarily by volumes and product mix and to a lesser extent by the Q1 benefit of the ELA equipment cancellation fee, resulting in non-GAAP gross margin of 38.7% for Q2.

Non-GAAP operating expenses increased by approximately $5 million dollars primarily due to deferred compensation liability increases as well as the decreased number of holidays and vacation taken in the March quarter when compared to our December quarter. This resulted in a non-GAAP operating margin of 14.2% for the fiscal second quarter and also came in slightly above the midpoint of our previously guided range. Adjusted EBITDA was 18.2% in fiscal Q2.

Tax

Finally, with regard to our non-GAAP tax rate, we realized a significant decrease in the rate from our previously guided range. For the most part, foreign income is taxed at a higher rate than domestic income. As a result of our geographic mix of income, we realized a more favorable tax rate.

Balance Sheet

Turning to the balance sheet, non-restricted cash, cash equivalents and short term investments were approximately $349 million dollars at the end of fiscal Q2, an increase of approximately $29 million compared to the end of last quarter. During the quarter, we repurchased shares totaling approximately $26 million dollars. We did not make any voluntary payments against our term loan. The outstanding amount of the term loan, in USD, is approximately $414 million dollars.

Accounts receivable DSO was 76 days, compared to 78 days in the prior quarter.
The net inventory balance at the end of the fiscal second quarter was approximately $484 million dollars, a decrease of $9 million, from the prior quarter.
And capital spending for the quarter was approximately $18 million dollars or 5% of sales.

Fiscal third quarter 2019 guidance

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

Revenue for fiscal Q3 is expected to be in the range of $335 to $355 million dollars.
We expect fiscal Q3 non-GAAP Gross Margin to be in the range of 37% to 40%. Non-GAAP gross margin excludes intangibles amortization of approximately $12.3 million dollars and stock compensation costs estimated at $1.3 million dollars.

Non-GAAP Operating Margin for fiscal Q3 is expected to be in the range of 11% to 14%. This excludes intangibles amortization estimated at a total of $14.4 million dollars and stock compensation expense of a total of approximately $9.3 million dollars.

Other income and expense is estimated to be an expense in the range of $3 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 Q3 non-GAAP tax rate to be in the range of 19% - 20%.

And, finally, we are assuming weighted average outstanding shares of approximately 24.2 million for the fiscal third quarter.

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