Conference Call Prepared Remarks
Coherent, Inc. Reports Second 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 its second 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 "outlook," "future," "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, 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.

Conference Call Prepared Remarks
Coherent, Inc. Reports Second Fiscal Quarter of 2018 Results
John Ambroseo, President and Chief Executive Officer

Thanks, Bret. I'd like to welcome everyone to our second fiscal quarter conference call. I am pleased to report that customer engagement remains very high, demand was strong in a number of key areas and the display market has lots of runway. So let's start there.

After recycled reports on microLED displays were recently published, we fielded a number of inquiries about how this technology potentially affects the OLED market and Coherent. I'd like to start by repeating some comments I made several quarters ago. The appeal of microLEDs is that they produce higher brightness and consume less power compared to other emissive devices such LCDs, LEDs and OLEDs.

The challenges in turning microLEDs into manufacturable displays include high process intensity and yield. There are two methods to make a full-color microLED display today. The first is to grow the emitters on wafers where any wafer consists of a single color in the red, green or blue. Emitters from different color wafers are then forward-transferred onto a display substrate. This involves separating the emitter from the growth substrate and using pick-and-place to relocate it to the display substrate. The total number of pixels drives the number of pick-and-place operations. In the case of a smartphone display, this is millions of pick-and-place transfers. Since some number of the transfers fail, repairs are necessary that further increase process intensity and costs.

It's important to point out a couple of things. To separate the emitters from the growth substrate, you have to break a very strong chemical bond that requires either high energy or

high intensity, which translates into excimer or ultrashort lasers, respectively. Coherent excimer lasers are being used to develop the forward transfer process. If microLEDs are ultimately successful and this technique was adopted, it is a net benefit to Coherent as we would now have content in the front plane of the display. The second method to make a full-color microLED display is to use a single color, likely blue, to excite a quantum dot overlay to produce red, green and blue pixels. This would allow the emitters to be removed in bulk - think of it as removing one inch square patches through laser lift-off - and transferred in bulk to the display substrate. The steps are greatly reduced from the pick-and-place approach, but the pixel density or PPI is determined by the pitch or emitter separation on the original growth substrate. In addition to PPI limitations, quantum dots are not 100% efficient so you sacrifice overall power. This may not be an issue for wall-plug powered displays, but it does offset the inherent power efficiency of microLEDs in battery-powered devices.
My comments up to this point have focused on the front plane of FPDs. The backplane is equally important to the conversation. Similar to the power hit from quantum dots, it would be counterproductive to use a microLED display with a less electrically efficient backplane in a battery-powered device. A LTPS backplane seems the likely choice.

To recap, if microLEDs are commercialized using current methods under development, it is a net benefit to Coherent. We also see LTPS being very compatible for all mobile displays. Putting it another way, we don't see microLEDs as a threat to our market position, rather we see them as potential market expansion into new display modalities for very large or very small screens, such as video walls or AR devices, respectively. And in our view, microLED is a technology that still needs to mature.

This means that OLEDs remain the display of choice for mobile displays, although capacity constraints are limiting their market share. Samsung is the only manufacturer capable of producing OLEDs with acceptable performance and quality. SDC claims that they can build approximately 500 million displays with their current capacity, which is largely consumed by internal demand for Galaxy phones and their largest external customer. An increase in OLED

market penetration into the remaining 1 billion handsets will require either Samsung to invest in additional capacity or one or more of their competitors to demonstrate a manufacturable design of acceptable quality. This is an important distinction. Much of the recent cycle has focused on a single handset, which uses one of the highest performing displays in production. It is not necessary to replicate the specifications of this display to address the other two-thirds of the market. As an example, BOE has been aggressively investing in R&D. They have shown a number of designs including foldable displays that are targeting the total available market. They have backed up their R&D commitment with capacity investments including two recently-announced, Gen 6 OLED fabs. These will be the first Gen 6 fabs outside of South Korea. The takeaway is simple: It is reasonable to discuss the timing of certain investments, such as Samsung's A5 fab, but we believe the future of OLEDs is very bright.

Service demand has been in-line with our recent commentary. Reported under-utilization at Samsung has been offset by an increase in the overall installed base. Second fiscal quarter FPD service revenue was similar to the prior quarter. We expect FPD service demand to accelerate between now and the end of the calendar year to support the introduction of new smartphone models.

Semiconductor capex is going strong for systems and service and resulted in high, sequential double-digit bookings growth in our second fiscal quarter. The order strength comes from high utilization rates that drive service revenues and new capacity investments for memory and logic devices in China. A cornerstone element of Made in China 2025 is to reduce the country's dependence on IC imports, which account for 80-90% of IC usage. China created a $150 billion investment fund to support their semiconductor evolution. The Chinese sense of urgency has likely increased following recent enforcement actions against ZTE. It is anticipated that Chinese investments will be sustained at or near the current level through calendar year 2019. Growth in other areas including self-driving vehicles, artificial intelligence and IoT devices is expected to accelerate over the next few years, which will require new capacity and/or the recommissioning

of older-node tools. As the leading supplier of inspection and metrology lasers, Coherent will benefit from each of these opportunities.

The advanced packaging market has been running at five-year highs over the last few quarters due to growth in advanced packaging designs among top tier smartphone manufacturers and HDI board usage amongst second-tier manufacturers. These trends are expected to continue as smartphone manufacturers jockey for market share.

Materials processing orders were very strong across all submarkets. Fiber laser orders were up significantly for cutting and welding applications. Chinese customers accounted for the growth in cutting for power levels up to 10kW. Welding orders were led by Tier 1 automotive component suppliers and EV battery manufacturers. Fiber components orders were also up from demand in China where we are one of the principal suppliers to Chinese domestic fiber laser companies. The market for lasers used in additive manufacturing of plastics and polymers remains robust. Bookings for medical device manufacturing workstations and marking systems increased on demand for cardiovascular therapy and dental appliances.

There has been tremendous growth in metal additive manufacturing. Industry data shows that metal AM machine unit sales grew 80% in 2017 versus 2016. Despite these impressive numbers, the market is constrained, in part, by process development and process knowledge. Many of the existing tool providers in metal AM are providing process development services and encoding the parameters into their tools. While this may ensure reproducibility and quality, it creates a logjam for innovation. One of the companies seeking to disrupt this approach is OR Laser, which has been developing its first metal AM tool. They wanted users to have access to process parameters to encourage collaboration, expand the knowledge base and shorten the development to manufacturing cycle. The company has also developed a complete AM software suite so no third party software is needed to go from CAD model to printed part. We believe this combination will be critical in opening up the metal AM market. We also see opportunities for process improvement in the types of lasers being applied

in metal AM. Given these synergies, we agreed to acquire OR Laser. The transaction was closed in early March 2018. Our first tool, the Laser Creator, is a compact workstation that combines the printer, powder bed, process control and other system hardware into a 19 inch cabinet standing approximately 6 feet tall. The compact nature and entry level price point make it ideally suited to build parts for the dental, medical and jewelry markets, as well as for process and product development. Future tools will address automotive and aerospace applications.

We had very good bookings for OEM instrumentation and components. Bioinstrumentation orders were up significantly on the timing of large annual and semi-annual orders. Medical OEM orders were also up on demand from ophthalmic, aesthetic and surgical consumables markets. We are seeing more and more opportunities in the aerospace and defense market for everything from large format imaging optics to directed energy applications due to our diverse capabilities and our U.S. manufacturing base.

I hope you've gleaned from my comments the number of opportunities that lie ahead of us. We have always been well-positioned in microelectronics and instrumentation, but through R&D programs and acquisitions, we have aligned ourselves with some very exciting applications in the materials processing market.

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

Conference Call Prepared Remarks
Coherent, Inc. Reports Second Fiscal Quarter of 2018 Results
Kevin Palatnik, Executive Vice President and Chief Financial Officer

Thanks, John.
Today, I'll first summarize fiscal second quarter 2018 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, restructuring costs, purchase accounting adjustments for inventory step amortization, 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.

Highlights of the Quarter

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

- Total Revenue of $481.1 million dollars,
- Non-GAAP Gross Margin of 47.7%,
- Non-GAAP Operating Margin of 26.2%,
- Adjusted EBITDA of 29.0%, and
- Non-GAAP EPS of $3.37

Sales

Net sales for fiscal second quarter were $481.1 million dollars, representing growth of 14% year over year. Sales came in virtually at the midpoint of our previously guided range, with sales in the Microelectronics and Materials Processing end markets increasing 23.9% and 6.5%, respectively, year over year.

Our revenue mix by market for Q2'18 was Microelectronics approximately 54%, Materials Processing 28%, OEM Components and Instrumentation 11% and Scientific & Government 7%. Geographically, Asia accounted for approximately 62% of revenues in the fiscal second quarter, the US 16%, Europe 19% 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 second quarter of 2018 were $132 million dollars or approximately 27% of sales representing an increase of approximately 21% year over year. Other product revenue consists of spare parts, related accessories and other consumable products and was approximately 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 second quarter revenues.

Gross Profit, Gross Margin, Operating Margin, EBITDA

Fiscal second quarter non-GAAP gross profit, excluding stock-based compensation costs, intangibles amortization, purchase accounting adjustments and restructuring was $229.5 million dollars. At 47.7% of sales for the quarter, non-GAAP Gross Margin came in slightly higher than the midpoint of the previously guided range.

Non-GAAP Operating Margin was 26.2% for the fiscal second quarter and was slightly below the midpoint of the guided range as a result of the acquisition made in the quarter and various accelerated R&D investments. Adjusted EBITDA was 29% in fiscal Q2.

Balance Sheet

Turning to the balance sheet, non-restricted cash, cash equivalents and short term investments were approximately $346 million dollars at the end of fiscal Q2, a decrease of approximately $77 million compared to the end of last quarter. During the quarter, while cash from Operations generated $68 million dollars, as John mentioned, we acquired OR Laser and consistent with our priority of using excess cash flow to de-lever the balance sheet, we made a voluntary 60M Euro payment against our outstanding debt. The total of the voluntary payments made to date is 285M Euros against our 670M Euro loan. The current amount of outstanding term loan debt in USD is 462 million dollars.

International cash was $185 million dollars or approximately 53% of the total cash and short term investment balance. Approximately 54% of the total cash and short term investments is denominated in dollars.
Accounts receivable DSO was 59 days, compared to 58 days in the prior quarter.

The net inventory balance at the end of the second quarter was approximately $493 million dollars, an increase of $60 million, of which, F/X was approximately $13 million and support for our Excimer and High Power Fiber Laser businesses drove the rest.

And Capital spending for the quarter was approximately $21 million dollars or 4.4% of sales.

Fiscal Third quarter 2018 guidance

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

Revenue for fiscal Q3 is expected to be in the range of $480 to $500 million dollars.

We expect fiscal Q3 non-GAAP Gross Margin to be in the range of 46% to 49%. Non-GAAP gross margin excludes intangibles amortization of approximately $13.1 million dollars, stock compensation costs estimated at $1.0 million dollars and purchase accounting adjustments of $0.4 million.

Non-GAAP Operating Margin for fiscal Q3 is expected to be in the range of 25% to 28%. This excludes intangibles amortization estimated at a total of $16.0 million dollars and stock compensation expense of a total of approximately $8.2 million dollars.

Other income and expense is estimated to be an expense in the range of $7.5 to $8.5 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 28% - 29%.

And, finally, we are assuming weighted average outstanding shares of approximately 25.1 million for the third quarter.

With regard to our participation at upcoming conferences, we'll be presenting at the Stifel Cross Sector Conference on June 11th in Boston and the CJS Summer Conference on July 10th in White Plains, New York.

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