Conference Call Prepared Remarks Q3'19

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 third 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 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 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, our ability to integrate the business of Rofin and other acquisitions successfully, manage our expanded operations and achieve anticipated synergies, our ability to successfully transfer the manufacturing of our High Power Fiber Lasers and related business and operations between facilities, our ability to successfully manage our planned site consolidation projects and achieve anticipated savings, 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.

Our June results were affected by ongoing challenges in the materials processing market and slightly lower service demand in FPD. I'll be discussing various topics around materials processing as well as optimism around the OLED business. I'll also review some recently announced site consolidation activity.

The microelectronics market was largely in-line with our prior commentary. Flat panel display system revenue reached a trough as we are completing deliveries of the phase 1 orders for OLED fabs. Service revenue came in lower than expected and is likely related to Samsung Display's announced receipt of a compensatory payment of more than $680 million dollars from a customer that didn't fulfill its volume commitment. Last quarter, we also reported that RFP activity was picking up, which is a key precursor to new order flow. We received the first new system order in the June quarter and we believe this marks the beginning of phase 2 in the OLED buildout. As a reminder, we and everyone else in the OLED universe are tracking more than twenty new fabs planned between now and 2023 with emphasis on flexible OLED. This will drive incremental investment in laser lift-off or LLO where we continue to hold substantial market share. Our data suggests that we won two-thirds of the orders and approximately 80% of the revenue in new LLO equipment orders over the last twelve months.

There are two other story lines in the display market that are noteworthy. JDI is struggling and will be further challenged if the 2020 iPhone® lineup goes all OLED. The company is reportedly in financing discussions with offshore investors. While the probable outcome is that Korea and China will battle over the OLED market, Japan may also play a role in this contest. The Japanese government recently announced plans to restrict the sale of key materials used in microelectronics manufacturing to Korea apparently as retaliation for a Korean court's decision regarding war time forced labor compensation. This could create shortages while Korean firms realign their supply chains, which would ultimately hurt Japanese suppliers. At this stage, it is unclear how this dispute will play out.

Our semicap business is still outperforming the broader wafer fab equipment market. New system orders have benefitted from both select deployment wins and strategic inventory builds from OEM customers. The service business has been brisk due to high utilization rates especially in legacy nodes used in automotive and IoT applications.

While orders were sequentially higher in June, the API market is shadowing broader WFE demand. PCB manufacturers are deferring new equipment orders until they have greater clarity on product configurations and volumes. We also note that a number of our industry brethren are espousing the benefits of ultrafast lasers in API applications. While we share the enthusiasm, we don't think many manufacturers have finalized technology deployment decisions, so stay tuned.

The global materials processing market is facing multiple challenges from depressed macro demand, concerns over trade and an increasingly aggressive pricing environment in China. PMI data is below the midpoint in the majority of large economies with the US being an outlier with a PMI just above 50. The global machine tool business has been particularly hard hit due to lower spending in the automotive and construction sectors. Reports from the German machine tool association suggest demand has been cut roughly in half over the last twelve months. Trade issues between the US and China are fostering short-termism between customers and manufacturers with everyone wanting to avoid tariff-inflated inventory. Perhaps the upcoming presidential election cycle will lead to some form of resolution.

Last month's Lasers Munich tradeshow was an eye-opener for the fiber laser market. There were strong declarative statements from Chinese vendors over the level of supply chain independence and the future ownership of market share in China. To reinforce the point, we were approached by one of our OEM customers with an offer to provide us with private-labelled, one kilowatt modules for $7500. They further suggested that they would work towards reducing the price to $5000 over two years. While these numbers might sound unreal, we would point out that they roughly correlate with end-user pricing and margins for the largest Chinese fiber laser manufacturer. It would appear fiber lasers are following the same trajectory as solar, LEDs and LCDs in China. Future competitiveness relies upon defensible device and process IP as well as supply chain excellence. These are some of the factors that led to us pivoting towards markets and applications for our fiber-based ARM lasers, which have demonstrated capability to solve manufacturing issues in electromobility for battery and electric motor production.

The OEM components and instrumentation market is solidly positioned for strong double-digit growth in fiscal 2019. The biggest contributor to year-over-year growth are sales to directed energy programs. Additional opportunities exist in target designation and countermeasures. The bioinstrumentation and OEM medical markets are performing well. We are working on plug-and-play subsystems for cytometry, imaging and sequencing that provide greater capability and drive higher ASPs.

In June, we launched two consolidation programs that will improve the efficiency of our business. We are exiting a leased facility in Santa Clara and consolidating fiber laser manufacturing into a single facility in Europe. We expect that the projects will be completed by the end of calendar 2020 and result in a run-rate reduction of approximately $24 million annually.

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

<u>Kevin Palatnik – EVP & Chief Financial Officer</u>
Thanks, John.

Today, I'll first summarize fiscal third quarter 2019 financial results then move to the outlook for fiscal Q4. 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 third quarter 2019 financial results for the company's key operating metrics were:

- Total Revenue of $339.2 million dollars,
- Non-GAAP Gross Margin of 37.9%,
- Non-GAAP Operating Margin of 12.1%,
- Adjusted EBITDA of 16.2%, and
- Non-GAAP EPS of $1.33.

Sales

Total revenue for the fiscal third quarter was $339.2 million dollars and came in slightly below the midpoint of our previously guided range due primarily to continued weakness in the Materials Processing end market and lower than expected service revenue in Display.

Our revenue mix by market for Q3 was Microelectronics approximately 42%, Materials Processing 30%, OEM Components and Instrumentation 19% and Scientific & Government 9%. Geographically, Asia accounted for approximately 51% of revenues in the fiscal third quarter, the US 24%, Europe 21% and rest of the world 4%. Asia includes two territories with revenues greater than 10% of sales.

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

Other product and service revenues for the fiscal third quarter were $118 million dollars or approximately 35% of sales. Other product revenue consists of spare parts, related accessories and other consumable products and was approximately 31% of sales. Revenue from services and service agreements was approximately 4% of sales. Total service revenues increased sequentially by approx. $2 million as OLED fab utilization started to increase for new releases in the fall.

Gross Profit, Gross Margin, Operating Margin, Adjusted EBITDA

Fiscal third quarter non-GAAP gross profit, excluding stock-based compensation costs, intangibles amortization, and restructuring was approximately $129 million dollars. Non-GAAP gross profit was impacted sequentially primarily by volumes and to a lesser extent product mix, resulting in non-GAAP gross margin of 37.9% for Q3.

Non-GAAP operating expenses decreased by approximately $4 million dollars primarily due to lower headcount related spending, higher customer reimbursements for R&D projects and deferred compensation liability decreases. This resulted in a non-GAAP operating margin of 12.1% for the fiscal third quarter and also came in slightly below the midpoint of our previously guided range. Adjusted EBITDA was 16.2% in fiscal Q3.

Balance Sheet

Turning to the balance sheet, non-restricted cash, cash equivalents and short term investments were approximately $319 million dollars at the end of fiscal Q3, a decrease of approximately $30 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. At the end of fiscal Q3, the outstanding amount of the term loan, in USD, was approximately $417 million dollars.

Accounts receivable DSO was 71 days, compared to 76 days in the prior quarter.

The net inventory balance at the end of the fiscal third quarter was approximately $469 million dollars, a decrease of $14 million, from the prior quarter.

And capital spending for the quarter was approximately $19 million dollars or 5.6% of sales.

Fiscal fourth quarter 2019 guidance

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

Revenue for fiscal Q4 is expected to be in the range of $320 to $340 million dollars.

We expect fiscal Q4 non-GAAP Gross Margin to be in the range of 36% to 39%. Non-GAAP gross margin excludes intangibles amortization of approximately $11.7 million dollars and stock compensation costs estimated at $1.2 million dollars.

Non-GAAP Operating Margin for fiscal Q4 is expected to be in the range of 8% to 11%. This excludes intangibles amortization estimated at a total of $13.8 million dollars and stock compensation expense of a total of approximately $9.7 million dollars.

Other income and expense is estimated to be an expense in the range of $2 to $3 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 Q4 non-GAAP tax rate to be approximately 20%.

And, finally, we are assuming weighted average outstanding shares of approximately 24 million for the fiscal fourth quarter.

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