Conference Call Prepared Remarks
Fourth Fiscal Quarter 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 fiscal quarter and fiscal year ending September 29, 2019.

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 manage our planned site consolidation projects and other cost reduction programs and to achieve the related anticipated savings and improved operational efficiencies, 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 and welcome, everyone, to the call.

The one word that best sums up our fourth fiscal quarter is mixed. Microelectronics is moving into positive territory and instrumentation remains robust. On the other side of the ledger, materials processing is beset by a number of challenges. It is tempting to project that we are at or are approaching the bottom, but we are mindful that irrational behavior from foreign and domestic competitors could further upend the market. The best defense in these circumstances is innovation, which has long been a hallmark for Coherent.

The trends in the various submarkets of microelectronics remain largely unchanged since last quarter's report. Bookings were sequentially up in the low double-digits by virtue of a new fab order in the FPD business, adding to the backlog position for fiscal 2020. While this is encouraging, we expect integrators and end users to continue to reduce their service spares inventory as they focus on short-term, cash conservation.

Several factors will influence OLED market performance in calendar 2020. The largest opportunity would be an all-OLED iPhone® lineup for the September 2020 release. Samsung has the capacity in place to address this opportunity and a standardized touch on encapsulation or Y-OCTA structure could reduce costs by 10-15%. It is widely known that LG and BOE are also vying for this business. One or both would have to pass engineering and production qualifications no later than the middle of calendar 2020 to have a legitimate chance. The stakes seem particularly high for LG, given their recent financial report citing a loss on display operations of roughly $370 million. Moving their mobile OLED business to profitability would provide clear benefits to their organization.

In China, display manufacturers are pursuing yield gains and government funding. An increasing number of SKUs from Chinese handset manufacturers points to higher OLED output, mostly for rigid displays, but there has not been a watershed moment in production. The question we are most frequently asked by the investment community, is to outline the timing of future fab investments. The short answer is timing has been and remains fluid. We anticipate additional orders in the first half of the year that will cover our build plan for fiscal 2020. The long-term view hasn't changed, other than JDI, which is reportedly facing funding challenges after the Harvest Tech deal fell through.

We've been reporting that our semicap business has been outperforming the broader wafer fab equipment market. Our semicap bookings grew by mid-single digits in fiscal 2019 compared to a projected decline of 10% or more for the overall WFE market. Our results reflect our market alignment. Investments in process control, where we are designed into multiple nodes, fared better than other tools in fiscal 2019. EUV use grew over the last year. Our Azure™ product platform is used in patterned wafer inspection in the EUV process. Finally, automotive and IoT pull remains robust, leading to solid service demand across a range of legacy nodes and laser architectures. Current semicap projections for calendar 2020 point to another decline in demand. We believe we will again outperform the market for the same reasons that lead to fiscal 2019 results.

It was a difficult year for the advanced packaging submarket. Most tool manufacturers have reported down years and end users are tightly managing utilization and investment. There are a few outliers that are seeing demand growth tied to new tools and/or capabilities. Returning to growth is dependent upon 5G, which offers something for everyone. Consumers benefit from faster speeds, wireless providers can address new markets, and mobile device manufacturers should see increased demand for 5G-enabled products. The laser solution of choice is still unclear, however, with CO_2, nanosecond UV and ultrafast lasers in the mix.

Our book-to-bill ratio in materials processing was above one for the first time in a number of quarters, but customer demand is still challenged on several fronts. Global PMIs are largely in negative territory, most notably for the Eurozone and specifically for Germany, which recently turned down its growth forecast from 1.5% to 1% for 2020. Several economies including the U.S. and China have bounced around PMI neutrality, but recent comments from Caterpillar and weak auto sales don't bode well for sustained, near-term improvement. The U.S.-China trade standoff further exacerbates the situation.

Within the materials processing submarkets, automotive is facing dual challenges of lower global demand and an accelerating transition from internal combustion engines or ICE to electro-mobility. Unfortunately, gains in the latter cannot offset declines in the former in the near term. There have been announcements from various Tier 1 component suppliers that they are cutting production for legacy components and laying off workers. Part of the aforementioned GM/UAW dispute involves moving workers from ICE to electric drive lines.

The slowdown in two-dimensional sheet metal cutting continued in the fourth fiscal quarter, which is partially attributable to the automotive sector. When volumes are down, price competition heats up. This means ASP erosion in the Chinese fiber laser market is unabated. The die board and textiles markets tell a different story. Demand is comparatively stable for a range of our CO_2 OEM lasers, subsystems and systems.

Medical device manufacturing or MDM was a bright spot in materials processing with all key regions moving towards historical run rates. Unlike the other submarkets, our MDM business is largely comprised of end user systems with higher levels of differentiation. The 2020 outlook is also encouraging with projected growth in North America, Europe and China.

Components orders from materials processing customers were flat overall, thanks in large part to a biannual order from a legacy customer. Current market dynamics paint a different picture. Overall market softness combined with aggressive pricing from Chinese diode laser manufacturers are leading to under-absorption in our semiconductor manufacturing unit. We are taking all available steps to reduce costs, but we will not be able to fully compensate for the loss of volume in the short term. However, this may reverse course over the next year or so. Chinese fiber laser manufacturers recognize that to compete at all power levels requires higher performing diodes at different wavelengths than what is available domestically. This opens a window for U.S. and German semiconductor laser manufacturers.

We had a very strong finish to a record year for our OEM components and instrumentation business. Orders, which set a quarterly record in the fourth fiscal quarter, and revenues both enjoyed strong double-digit, annual growth.

Our bioinstrumentation business benefitted from a number of factors including increased clinical adoption of cell-based therapies such as immuno-oncology. To support this trend, we've introduced a new subsystem that offers enhanced capabilities in a smaller footprint. We're also well-positioned to support customers who are combining cytometry and imaging to gain even more information about cell size, cell shape and the distribution of labelled (i.e., target) biomolecules. Our recently launched Axon™ platform looks like an ideal solution for clinical imaging applications.

The medical OEM business saw growth in dental, aesthetic and surgical consumables. The dental market is driven by a lead customer that is helping transform the patient experience. Vanity procedures like hair removal and fat emulsification are driving growth in our aesthetic sales. A higher number of lithotripsy procedures is behind the improvement in surgical consumables.

The defense and aerospace business also had an excellent year. Revenue from directed energy programs doubled year-over-year. Orders for space and ground-based telescopes was very healthy. We are being invited to participate in new programs that can create an attractive funnel over the next few years.

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

Kevin Palatnik – EVP & Chief Financial Officer

Thanks, John.

Today, I'll first summarize fiscal fourth quarter 2019 financial results then move to the outlook for fiscal Q1 2020. 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 fourth quarter 2019 financial results for the company's key operating metrics were:

- Total Revenue of $335.5 million dollars,
- Non-GAAP Gross Margin of 36.4%,
- Non-GAAP Operating Margin of 9.6%,
- Adjusted EBITDA of 14.3%, and
- Non-GAAP EPS of $0.89.

Sales

Total revenue for the fiscal fourth quarter was $335.5 million dollars and came in above the midpoint of our previously guided range due primarily to increased shipments in our OEM instrumentation and components business, particularly in the Aero & Defense market.

Our revenue mix by market for Q4 was Microelectronics approximately 42%, Materials Processing 28%, OEM Components and Instrumentation 21% and Scientific & Government 9%. Geographically, Asia accounted for approximately 49% of revenues in the fiscal fourth quarter, the US 27%, Europe 20% 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 fourth quarter revenues.

Other product and service revenues for the fiscal fourth quarter were $114 million dollars or approximately 34% of sales. Other product revenue consists of spare parts, related accessories and other consumable products and was approximately 30% of sales. Revenue from services and service agreements was approximately 4% of sales. Total service revenues decreased sequentially by approx. $4 million as our integrators and end users focus on conserving cash by keeping their service stock to minimal levels.

Gross Profit, Gross Margin, Operating Margin, Adjusted EBITDA

Fiscal fourth quarter non-GAAP gross profit, excluding stock-based compensation costs, intangibles amortization, and restructuring was approximately $122 million dollars. Non-GAAP gross profit was impacted primarily by higher than normal inventory reserves, resulting in non-GAAP gross margin of 36.4% for Q4.

Non-GAAP operating expenses increased by approximately $2 million dollars, primarily due to deferred compensation plan liability increases that are posted to OPEX with the approximate offset posted in Other Income & Expense. This resulted in a non-GAAP operating margin of 9.6% for the fiscal fourth quarter and came in slightly above the midpoint of our previously guided range. Adjusted EBITDA was 14.3% in fiscal Q4.

Summarizing the Income statement, we were above the midpoint of our previously guided range for both Revenue and Operating margin yielding higher than expected operating income, however, there were more than offsetting impacts below the line. Discount rates across Europe and in particular Germany have decreased sequentially adding to our pension cost recorded in Other Income and Expense. In addition, a higher than expected non-GAAP tax rate also impacted overall net income.

Balance Sheet

Turning to the balance sheet, non-restricted cash, cash equivalents and short term investments were approximately $306 million dollars at the end of fiscal Q4, a decrease of approximately $13 million compared to the end of last quarter. We did not make any voluntary payments against our term loan, however, we did repay $30 million against our line of credit. At the end of fiscal Q4, the outstanding amount of the term loan, in USD, was approximately $399 million dollars.

Accounts receivable DSO was 72 days, compared to 71 days in the prior quarter.

The net inventory balance at the end of the fiscal fourth quarter was approximately $443 million dollars, a decrease of $27 million, from the prior quarter.

Fiscal first quarter 2020 guidance

Now, I'll turn to our outlook for our first fiscal quarter of 2020.

Revenue for fiscal Q1 is expected to be in the range of $305 to $325 million dollars.

We expect fiscal Q1 non-GAAP Gross Margin to be in the range of 36.5% to 39.5%. Non-GAAP gross margin excludes intangibles amortization of approximately $11.6 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 7.5% to 10.5%. This excludes intangibles amortization estimated at a total of $13.1 million dollars and stock compensation expense of a total of approximately $10.2 million dollars.

Other income and expense is estimated to be an expense in the range of $5 to $6 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 24%-25%.

And, finally, we are assuming weighted average outstanding shares of approximately 24.1 million for the fiscal first quarter.

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