Coherent, Inc.

Conference Call Prepared Remarks Q3'15

Helene Simonet-EVP & Chief Financial Officer

Good afternoon everyone and thank you for joining us on today's call. I will provide financial information and John Ambroseo, our President and CEO, will provide a business overview.

As a reminder, any guidance and any statements in today's conference call pertaining to future guidance, market trends, plans, events or performance, are forward-looking statements that involve risks and uncertainties, and actual results may differ significantly. We encourage you to refer to the risk disclosures and critical accounting policies described in the Company's reports on Forms 10-K, 10-Q and 8-K, as applicable and as filed from time-to-time by the Company. These forward looking statements are subject to the safe harbor provisions of the private securities litigation reform act. The Company undertakes no obligation to update any forward looking statements.

The full text of today's prepared remarks and trended GAAP and non-GAAP supplemental financial information including bookings and revenues by market 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

Let me first give you the financial highlights of our third fiscal quarter. We ended the quarter with revenues of $188.5 million and pro forma earnings of $0.82 per diluted share. The third quarter revenue does not include the third LB 1500 ELA system that we had previously indicated may ship in the third quarter. The customer requested that we deliver this unit in the fourth quarter, as originally scheduled, resulting in approximately $20 million revenue shift from the third to the fourth quarter.

The high point of our third quarter performance is the sizeable step up in the pro forma gross profit percentage which led to a sequential increase in our pro forma EBITDA% to 18.4% compared to 17.6% last quarter.

Sales

Net sales for the third quarter of $188.5 million declined $8.0 million or 4.1% compared to the same quarter a year ago which is the result of the unfavorable impact of exchange rate fluctuations. Compared to the previous quarter, net sales decreased $15.2 million or 7.5% which is partially due to the Linebeam 1500 ELA system shift to the fourth quarter and a slowdown in semiconductor investments. In addition, our medical ophthalmic revenues declined following a very strong second quarter.

The third quarter's ending shippable backlog, defined as shippable within the next 12 months, is approximately $305 million including $114 million, or 37%, flat panel display shippable bookings. The comparable shippable backlog at the end of last quarter was approximately $315 million including $116 million, or 37%, flat panel display shippable bookings.

Geographically, Asia accounted for 50% of the Company's revenues, US 28%, Europe 16% and rest of the world 6%.

Service revenues for the third quarter of approximately $57 million compare to a record second quarter of almost $66 million. The decline occurred across all the major markets. Service revenues represented 30% of the company's revenues and were in line with our forecasts.

We had one customer in Japan, an integrator to flat panel display manufacturers, who contributed more than 10% of the Company's third quarter revenue.

Pro Forma Gross Profit, Operating Expenses

The third quarter pro forma gross profit, excluding $0.7 million stock compensation charges, $1.3 million intangibles amortization and a $1.3 million accrual for an ongoing multi-year customs audit was $82.1 million, or 43.5% of sales, which is 100 basis points above the high end of our guidance range. The sequential increase of 160 basis points is mainly the result of a more favorable product mix in the Microelectronics and OEM components and instrumentation markets, lower warranty expenses and the favorable impact of a weaker Euro versus the dollar, partially offset by the unfavorable impact of a weaker yen versus the dollar.

Pro forma period expenses, excluding stock compensation charges, intangibles amortization and the impairment of our SiOnyx investment, were 28.4% of sales and declined almost $3 million compared to the previous quarter.

Balance Sheet

Our cash and cash equivalents balance for the quarter was $336.8 million which represents a sequential decrease of $7.7 million compared to last quarter. About 78% of our cash is denominated in dollars; 25% of the total cash is held in the United States and 75% internationally.

Cash flow from operations for the third quarter was $11.6 million negative mainly as a result of increased accounts receivable. DSO at the end of the third quarter increased to 69 days primarily due to unfavorable sales linearity, particularly in Japan, and the timing of certain payments. Inventory turns declined to 2.8 turns and was negatively impacted by the shipment delay of our Linebeam 1500 ELA system. Year to date cash flow from operations remains strong at approximately $69 million and increased 6% versus the comparable period last year.

Capital spending for the quarter was $4.0 million or 2.1% of sales, bringing the year to date spending to $16.2 million or 2.7% of sales.

At the end of July, we acquired the assets of Raydiance, a private company, and the Tinsley Optics business of L-3 Communications, for a combined $9.3 million in cash, excluding transaction costs, which will be reflected in our fourth quarter ending cash balance. The acquisitions are projected to be accretive towards the end of fiscal 2016. Since both transactions closed during the last week, we plan on providing purchase accounting specifics at our next conference call. The guidance for the fourth quarter will only include activity for two months on a pro forma basis.

Fourth quarter of fiscal year 2015 guidance

Our current outlook for the fourth quarter revenue ranges from $205 to $215 million and is inclusive of our third Linebeam 1500 ELA system which was shifted from the third to fourth quarter and approximately $2 to $3 million revenue from the recent acquisitions.

We project fourth quarter pro forma gross profit percentage to be in the range of 42.5% to 43.0% of sales, inclusive of the recently acquired businesses. Both of the businesses are expected to be dilutive to our pro forma gross profit percentage until the end of fiscal 2016. As a reminder, the quarterly guidance excludes intangibles amortization of $1.3 million and stock compensation costs estimated at $0.7 million.

We anticipate the third quarter pro forma period expenses to be approximately 26.5% to 27.0% of sales inclusive of approximately $1.5 million of expense increase for the acquired businesses. The guidance excludes intangibles amortization estimated at $0.7 million and stock compensation costs of approximately $4.0 million.

Other income and expense is estimated to be immaterial. We do not include transaction gains and losses related to future changes in foreign exchange rates in our guidance.

We project our pro forma tax rate to be approximately 27% for the fiscal year.

We forecast our full fiscal 2015 capital spending to be approximately 3.0% to 3.5% of sales.

And, we are assuming weighted outstanding shares for the fourth quarter of approximately 25.0 million.

I will now turn over the call to John Ambroseo, our President and CEO.

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John Ambroseo – President & Chief Executive Officer

Thanks, Leen.

Good afternoon everyone and welcome to our third fiscal quarter conference call.

We have had a dynamic few months at Coherent. It began with a customer asking us to pull in a shipment of the most complex product we manufacture and later request that we go back to the original ship date. We had a fantastic showing at Lasers Munich. We introduced about a dozen new products and captured a record number of leads. I'll highlight three of the new releases during my prepared remarks. We also completed two asset acquisitions. One addresses short pulse processing applications and the other protects a critical piece of our supply chain.

Quarterly Results

Second quarter bookings of $176.7 million decreased 19.9% sequentially and 27.8% compared to the prior year period. The large differences are primarily due to the timing of system orders for FPD annealing lasers. The book-to-bill for the second quarter was 0.94.

Scientific

Scientific orders of $29.1 million increased 10.0% sequentially and 1.1% compared to the prior year period.

The sequential order growth was led by our Chameleon™ product family in biological imaging and neuroscience. Most of the increase came from North America. Europe and Japan posted modest improvements. The Chameleon mix is evolving from traditional Ti:sapphire-based lasers to the fiber-based Chameleon Discovery™ as it is qualified by more of our imaging partners. Discovery accounted for roughly 20% of new Chameleon orders in the third quarter and we expect its market share and mix contribution to continue to rise. Ultrafast amplifier orders also rose. The current trend is for individual researchers to rely upon integrated, single-box solutions such as the Astrella™ or Libra™ platforms while large multi-user facilities favor the configurable Legend™ system.

We introduced several new products at Laser Munich that will serve the research market. The Fidelity HP™ is an all-fiber ultrafast laser that is well suited for use in advanced neurophysiology research. The Revolution™ is a new pump laser for ultrafast amplifier systems built using HALT and HAAS testing. The Monaco™, while designed for commercial applications, is also suitable for use in biological imaging and time-resolved studies of advanced solid-state materials such as novel semiconductors and nanopolymers.

Instrumentation and OEM Components

Instrumentation and OEM components orders of $30.8 million decreased 46.0% against the record-setting prior quarter and 43.7% versus the second quarter of fiscal 2014. The large swings reflect order timing from various OEMs.

The bioinstrumentation business is enjoying meaningful investments on different fronts driven by a goal of precise, personalized medicine. In cytometry, the move to desktop instruments requires miniaturized components. We addressed the first wave of this transition with our Cube™ and BioRay™ products. Our next generation will shrink even further and include subsystem capabilities. Many sequencing applications are moving closer to deployment and we have secured key design wins with U.S. and Asian OEMs. The first of these next gen sequencers should debut in the second half of next year with more to follow in 2017.

The medical OEM market is also strong, especially for vision treatment and eye disease management. While modern cataract treatment is amazing, it tends to be a one-size-fits-all approach. Ophthalmologists would prefer to have greater performance flexibility and control over the laser parameters so as to optimize individual patient treatment. To this end, we developed the Monaco™, an all-fiber ultrafast laser with variable pulsewidth and power capability. Monaco can be quickly and easily adjusted to perform the four key processes in cataract surgery including making the corneal incision, fracturing the cataract, excising the lens sack and prepping the lens bed. The fracture or laser phacoemulsification especially benefits from variable performance since many factors, such as age and UV exposure, influence the density of a cataract. Monaco was introduced at Lasers Munich and initial shipments will occur this fiscal year. We expect first volume orders to occur in fiscal 2016.

Microelectronics

Microelectronics orders of $90.8 million decreased 13.9% sequentially and 26.5% compared to the prior year period.

News from the semiconductor market continues to worsen with 2015 growth projections reduced to low single digits. While utilization rates remain high as do the associated service revenues, new laser demand has all but ceased. In this climate we expect customers will burn down inventory and maximize cash. This move has eliminated several million dollars of previously scheduled, new system shipments from our Q4 revenues.

The FPD market remains robust despite the flip-flop on the Linebeam 1500 delivery. High-definition displays in mobile applications should grow at three times the rate of mobile device growth according to Gartner. When you add ppi and screen size growth, it leads to significant capital investment from Korea, China and Japan. Incremental to mobile displays is a projected rise in automotive applications using flexible OLED. In response to these opportunities, several capital projects have already been announced by LG, Samsung, JDI and others. As previously communicated the orders will come over the course of the current and next fiscal quarters. Some of the orders will be for our Linebeam 750 product and a number will be for larger formats at or above 1000mm. We have multiple vendors who provide optics for the 750. We had developed L-3/Tinsley as a sole source supplier for our 1300nm and 1500nm optics. L-3 made a strategic decision to exit this business and we opted to acquire the business rather than face supply chain risk or possible price increases from a new owner. Tinsley is a specialized manufacturer of high precision optical components and sub-systems sold primarily in the aerospace and defense industry. They have unique capabilities in the fabrication of very large lens arrays, such as those utilized in our Excimer Laser Annealing (ELA) linebeams. As a strategic optics supplier they have helped Coherent scale line-beam sizes beyond 1.5m, enabling our mobile display customers to process up to the latest Generation 6 glass sizes in a single pass, enabling increased yield and lowest costs per panel. We plan to continue to serve Tinsley's core aerospace & defense specialty optics markets, in addition to enabling increased vertical integration in our ELA business. Going forward the business will be renamed Coherent Integrated Optical Systems (IOS).

We continue to see positive signs for recovery in the CO_2 via drilling market. OEM customers are engaged in a number of projects with packaging houses. We would expect several of these opportunities to utilize our new J-Series lasers due to advances in integration, reliability and service. Laser direct imaging has morphed into a two-tier market where lasers are used for high throughput/high resolution applications and UV diodes are used for low resolution work. Similar to semicap, utilization of lasers remains high, yielding solid service revenue.

In previous conference calls, I had mentioned a future move to similar via sizes. We introduced a new J-Series laser at Lasers Munich that could be the key to smaller hole sizes. The new laser resembles a standard CO_2 laser, but is based upon carbon monoxide or CO gas that emits light at five microns rather than ten microns. The wavelength difference supports hole sizes down to 25 microns with a 3-pulse drilling process to similar CO_2 lasers. Our CO laser can deliver similar output power to its CO_2 cousin so throughput should be largely unaffected. The CO laser will sell at a slight premium to CO_2, but it will be considerably less expensive than other potential light sources. We have begun working with one of the leaders in via drilling to demonstrate the capabilities of the laser as well as the overall tool architecture. The time to revenue will be longer due to process and tool development, but the market is quiet sizable with approximately 10,000 laser via drilling systems in the field today.

Short pulse processing has been an activity rich environment that promised large orders for successful solutions. We had a few of these, but the follow-on orders have been slow or failed to materialize. The culprit is the consumer electronics products that utilize the short-pulse processing techniques have failed to meet their market acceptance and volume goals. We have seen a couple more examples of this recently, resulting in the deferral of approximately $10 million of sales originally planned for the current quarter. This figure is incremental to what we have previously reported. While it might be tempting, ignoring these opportunities is not the right answer. We need to position ourselves to better evaluate potential. To that end, we have purchased the assets of Raydiance, Inc and re-hired a core team of its former employees. Raydiance has built a strong share and application know-how position in the ultrafast laser and optical sub-system markets for precision micro-materials processing, specifically automotive fuel injectors and medical device manufacturing. The recent introduction of the new Monaco and Rapid FX ultrafast laser products from Coherent, together with Raydiance expertise in ultrafast optical sub-systems, will enable Coherent to provide an unmatched portfolio of laser and optical sub-system solutions to address our customer's needs in both micro-material processing and micro-electronics. The former Raydiance business will be combined with the recent Tinsley specialty optics acquisition as part of Coherent Integrated Optical Systems (IOS).

Materials Processing

Materials processing orders of $26.0 million were down 17.9% sequentially and 30.7% versus the prior year period.

Volatile bookings are not new in our materials processing business. There were a number of positive Q3 takeaways that were masked by the absolute result. We received record CO_2 orders for marking in China. This is very encouraging given the high level of domestic and international competition suggesting that customers recognize the performance and reliability advantages of our products. Included in the CO_2 orders were first articles for a competitive displacement of a major customer. If successful, we will see volume orders in fiscal 2016. We also received initial bookings for a major converting project using E-1000 lasers and J-3 lasers for denim marking. Both opportunities could lead to very attractive fiscal 2016 revenue. On the downside, we have seen an investment slowdown for cladding in the oil and gas industry. While not large dollars, it highlights the sensitivity that consumer demand plays in this market.

The big news for us was the formal launch of our second generation Highlight™ FL fiber laser system at Lasers Munich. The new architecture is easily scalable by aggregating building blocks. The initial range is 2-4kW with higher powers becoming available in the future. The Gen 2 device uses house water for cooling as opposed to deionized water required in the Gen 1 product. We can offer various levels of integration from a fully integrated, turnkey box all the way down to components and subsystems. This allows customers of different scales and capabilities to select the best option for their specific needs. We also provided processing results for a range of materials. The cutting speed and quality were consistent with the needs of the end users. We believe our results for high-reflectivity metals are superior to any other source in the market today. The response from customers was very encouraging, including multiple meetings with tier 1 users. We will be scheduling demos over the next several months. If successful, we would expect revenue opportunities to emerge in the second half of fiscal 2016.

Wrap

The new products that were recently released at the Munich show offer customers some very impressive capabilities and we look forward to telling more of the story over the coming quarters. As these new products transfer to manufacturing, we will be reducing our R&D spend. In addition, we have been working on transferring all activities from our Hanover facility, home of the former Innolight business, to other European locations. The transfer is complete and the last costs will be recorded in the current quarter. On a combined basis, these actions will reduce expenses by $5 million per year beginning in Q1 of fiscal 2016.

We'll be presenting at the Needham Industrial conference on Thursday, August 6th in New York.

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

SPECIAL NOTE REGARDING NON-GAAP FINANCIAL MEASURES

NON-GAAP FINANCIAL MEASURES: Coherent utilizes a number of different financial measures, both GAAP and non-GAAP, in analyzing and assessing the overall business performance, for making operating decisions and for forecasting and planning future periods. Coherent considers the use of non-GAAP financial measures helpful in assessing its current financial performance, ongoing operations and prospects for the future. Ongoing operations are the ongoing revenue and expenses of the business, excluding certain costs that Coherent does not anticipate to recur on a quarterly basis or which do not reflect ongoing operations. While Coherent uses non-GAAP financial measures as a tool to enhance its understanding of certain aspects of its financial performance, Coherent does not consider these measures to be a substitute for, or superior to, the information provided by GAAP financial measures. Consistent with this approach, Coherent believes that disclosing non-GAAP financial measures to the readers of its financial statements provides such readers with useful supplemental data that, while not a substitute for GAAP financial measures, allows for greater transparency in the review of its financial and operational performance. In assessing the overall health of its business, Coherent excluded items in the following general categories described below:

Pro forma Net income (loss) and net income (loss) per basic or diluted share. We have excluded certain recurring and non-recurring items in order to enhance investors' understanding of our ongoing operations and to compare these results across multiple fiscal periods, particularly where a one-time event may have an impact in one fiscal quarter and not another.

Pro forma EBITDA is defined as operating income adjusted for depreciation, amortization, stock compensation expenses, major restructuring costs and certain other non-operating income and expense items. We have excluded these items in order to enhance investors' understanding of our ongoing operations. This measure is used by some investors when assessing the performance of Coherent.

Each of the non-GAAP financial measures described above, and used herein, should not be considered in isolation from, or as a substitute for, a measure of financial performance prepared in accordance with GAAP. Further, investors are cautioned that there are inherent limitations associated with the use of each of these non-GAAP financial measures as an analytical tool. In particular, these non-GAAP financial measures are not based on a comprehensive set of accounting rules or principles and many of the adjustments to the GAAP financial measures reflect the exclusion of items that are recurring and will be reflected in Coherent's financial results for the foreseeable future. In addition, other companies, including other companies in Coherent's industry, may calculate non-GAAP financial measures differently than Coherent does, limiting their usefulness as a comparative tool.