

II-VI INC
Form 10-Q
May 09, 2018

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended March 31, 2018

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
for the transition period from to .

Commission File Number: 0-16195

II-VI INCORPORATED

(Exact name of registrant as specified in its charter)

PENNSYLVANIA	25-1214948
(State or other jurisdiction of	(I.R.S. Employer
incorporation or organization)	Identification No.)

375 Saxonburg Boulevard	
Saxonburg, PA	16056
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: 724-352-4455

N/A

(Former name, former address and former fiscal year, if changed since last report)

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Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date:

At May 2, 2018, 62,544,530 shares of Common Stock, no par value, of the registrant were outstanding.

II-VI INCORPORATED

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PART I - FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

II-VI Incorporated and Subsidiaries

Condensed Consolidated Balance Sheets (Unaudited)

(\$000)

	March 31, 2018	June 30, 2017
Assets		
Current Assets		
Cash and cash equivalents	\$263,244	\$271,888
Accounts receivable - less allowance for doubtful accounts of \$1,143 at March 31, 2018 and \$1,314 at June 30, 2017	192,766	193,379
Inventories	249,548	203,695
Prepaid and refundable income taxes	7,116	6,732
Prepaid and other current assets	33,471	26,602
Total Current Assets	746,145	702,296
Property, plant & equipment, net	507,690	367,728
Goodwill	274,516	250,342
Other intangible assets, net	129,142	133,957
Investments	68,222	11,727
Deferred income taxes	2,618	3,023
Other assets	8,901	8,224
Total Assets	\$1,737,234	\$1,477,297
Liabilities and Shareholders' Equity		
Current Liabilities		
Current portion of long-term debt	\$20,000	\$20,000
Accounts payable	77,270	65,540
Accrued compensation and benefits	53,856	58,178
Accrued income taxes payable	18,342	12,178
Other accrued liabilities	33,118	29,056
Total Current Liabilities	202,586	184,952
Long-term debt	430,992	322,022
Capital lease obligation	22,574	23,415
Deferred income taxes	27,046	15,345
Other liabilities	38,864	31,000
Total Liabilities	722,062	576,734
Shareholders' Equity		
Preferred stock, no par value; authorized - 5,000,000 shares; none issued	-	-
Common stock, no par value; authorized - 300,000,000 shares; issued - 74,925,863 shares at March 31, 2018; 74,081,451 shares at June 30, 2017	346,500	269,638
Accumulated other comprehensive income (loss)	17,107	(13,778)
Retained earnings	808,897	748,062

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	1,172,504	1,003,922
Treasury stock, at cost - 12,458,693 shares at March 31, 2018 and 10,940,062 shares at June 30, 2017	(157,332)	(103,359)
Total Shareholders' Equity	1,015,172	900,563
Total Liabilities and Shareholders' Equity	\$1,737,234	\$1,477,297

- See notes to condensed consolidated financial statements.

II-VI Incorporated and Subsidiaries

Condensed Consolidated Statements of Earnings (Unaudited)

(\$000 except per share data)

	Three Months Ended March 31,	
	2018	2017
Revenues	\$294,746	\$244,987
Costs, Expenses and Other Expense (Income)		
Cost of goods sold	176,361	147,277
Internal research and development	30,560	25,380
Selling, general and administrative	53,087	43,291
Interest expense	5,014	1,936
Other expense (income), net	(1,496)	(2,164)
Total Costs, Expenses & Other Expense (Income)	263,526	215,720
Earnings Before Income Taxes	31,220	29,267
Income Taxes	1,122	6,837
Net Earnings	\$30,098	\$22,430
Basic Earnings Per Share	\$0.48	\$0.36
Diluted Earnings Per Share	\$0.45	\$0.35

- See notes to condensed consolidated financial statements.

II-VI Incorporated and Subsidiaries

Condensed Consolidated Statements of Earnings (Unaudited)

(\$000 except per share data)

	Nine Months Ended March 31,	
	2018	2017
Revenues	\$837,719	\$698,329
Costs, Expenses and Other Expense (Income)		
Cost of goods sold	503,926	418,754
Internal research and development	83,898	70,844
Selling, general and administrative	152,833	128,865
Interest expense	13,303	4,547
Other expense (income), net	(4,228)	(9,611)
Total Costs, Expenses & Other Expense (Income)	749,732	613,399
Earnings Before Income Taxes	87,987	84,930
Income Taxes	27,152	22,303
Net Earnings	\$60,835	\$62,627
Basic Earnings Per Share	\$0.97	\$1.00
Diluted Earnings Per Share	\$0.93	\$0.97

- See notes to condensed consolidated financial statements.

II-VI Incorporated and Subsidiaries

Condensed Consolidated Statements of Comprehensive Income (Unaudited)

(\$000)

	Three Months Ended March 31, 2018		2017		Nine Months Ended March 31, 2018		2017	
Net earnings	\$30,098	\$22,430	\$60,835	\$62,627				
Other comprehensive income (loss):								
Foreign currency translation adjustments	15,703	3,002	30,885	(12,145)				
Amortization of net actuarial gains and losses, net of taxes of (\$32) and \$0 for the three and nine months ended March 31, 2018, respectively, and (\$40) and \$45 for the three and nine months ended March 31, 2017, respectively	(118)	(149)	-	163				
Comprehensive income	\$45,683	\$25,283	\$91,720	\$50,645				

- See notes to condensed consolidated financial statements.

II-VI Incorporated and Subsidiaries

Condensed Consolidated Statements of Cash Flows (Unaudited)

(\$000)

	Nine Months Ended March 31,	
	2018	2017
Cash Flows from Operating Activities		
Net earnings	\$60,835	\$62,627
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	47,157	35,190
Amortization	10,992	9,532
Share-based compensation expense	11,562	8,695
Losses (gains) on foreign currency remeasurements and transactions	789	(3,633)
Earnings from equity investments	(2,607)	(654)
Deferred income taxes	(1,612)	248
Increase (decrease) in cash from changes in (net of effect of acquisitions):		
Accounts receivable	5,644	(8,220)
Inventories	(33,446)	(20,273)
Accounts payable	12,205	7,610
Income taxes	9,558	2,958
Accrued compensation and benefits	(6,039)	(12,387)
Other operating net assets	(1,093)	(3,321)
Net cash provided by operating activities	113,945	78,372
Cash Flows from Investing Activities		
Additions to property, plant & equipment	(116,477)	(99,135)
Purchases of businesses	(80,503)	(580)
Purchase of equity investment	(51,655)	-
Other investing activities	429	1,707
Net cash used in investing activities	(248,206)	(98,008)
Cash Flows from Financing Activities		
Proceeds from issuance of 0.25% convertible senior notes due 2022	345,000	-
Proceeds from borrowings under Credit Facility	100,000	64,000
Payments on borrowings under Credit Facility	(277,000)	(20,000)
Purchases of treasury stock	(49,875)	-
Proceeds from exercises of stock options	8,836	14,625
Payments in satisfaction of employees' minimum tax obligations	(4,040)	(3,407)
Debt issuance costs	(10,061)	(1,384)
Net cash provided by financing activities	112,860	53,834
Effect of exchange rate changes on cash and cash equivalents	12,757	(5,062)
Net (decrease) increase in cash and cash equivalents	(8,644)	29,136
Cash and Cash Equivalents at Beginning of Period	271,888	218,445
Cash and Cash Equivalents at End of Period	\$263,244	\$247,581
Cash paid for interest	\$4,680	\$3,937
Cash paid for income taxes	\$16,588	\$16,852

Non-cash transactions:

Capital lease obligation incurred on facility lease	\$-	\$25,000
Additions to property, plant & equipment included in accounts payable	\$3,388	\$6,521

- See notes to condensed consolidated financial statements.

e II-VI Incorporated and Subsidiaries

Condensed Consolidated Statement of Shareholders' Equity (Unaudited)

(000)

	Common Stock		Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock		Total
	Shares	Amount	(Loss)		Shares	Amount	
Balance - June 30, 2017	74,081	\$269,638	\$ (13,778)	\$748,062	(10,940)	\$(103,359)	\$900,563
Shares issued under share-based compensation plans	845	8,836	-	-	-	-	8,836
Shares acquired in satisfaction of minimum tax withholding obligations	-	-	-	-	(109)	(4,040)	(4,040)
Net earnings	-	-	-	60,835	-	-	60,835
Purchases of treasury stock	-	-	-	-	(1,415)	(49,875)	(49,875)
Treasury stock under deferred compensation arrangements	-	58	-	-	5	(58)	-
Foreign currency translation adjustments	-	-	30,885	-	-	-	30,885
Equity portion of convertible debt, net of issuance costs of \$1,694	-	56,406	-	-	-	-	56,406
Share-based compensation expense	-	11,562	-	-	-	-	11,562
Balance - March 31, 2018	74,926	\$346,500	\$ 17,107	\$808,897	(12,459)	\$(157,332)	\$1,015,172

- See notes to condensed consolidated financial statements.

II-VI Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

Note 1. Basis of Presentation

The condensed consolidated financial statements of II-VI Incorporated (“II-VI”, the “Company”, “we”, “us” or “our”) for the three and nine months ended March 31, 2018 and 2017 are unaudited. In the opinion of management, all adjustments considered necessary for a fair presentation for the periods presented have been included. All adjustments are of a normal recurring nature unless disclosed otherwise. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) have been condensed or omitted. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended June 30, 2017. The consolidated results of operations for the three and nine months ended March 31, 2018 are not necessarily indicative of the results to be expected for the full fiscal year. The June 30, 2017 Condensed Consolidated Balance Sheet information was derived from the Company’s audited financial statements.

Note 2. Recently Issued Financial Accounting Standards Adopted Pronouncements

In May 2017, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2017-09, Compensation-Stock Compensation (Topic 718): Scope of Modification Accounting. ASU 2017-09 provides clarification on when modification accounting should be used for changes to the terms or conditions of a share-based payment award. This ASU does not change the accounting for modifications but clarifies that modification accounting guidance should only be applied if there is a change to the value, vesting conditions, or award classification and would not be required if the changes are considered non-substantive. The new guidance is applied prospectively to awards modified on or after the adoption date. The adoption of this standard did not have a material effect on the Company’s Consolidated Financial Statements.

In January 2017, the FASB issued ASU 2017-04, Intangibles – Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment. This standard removes the second step of the goodwill impairment test, where a determination of the fair value of individual assets and liabilities of a reporting unit were needed to measure the goodwill impairment. Under this updated standard, goodwill impairment will now be the amount by which a reporting unit’s carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The Company has adopted this standard for any impairment test that is performed after July 1, 2017 as permitted under the standard.

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. This update simplifies several aspects of the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, and classification in the statement of cash flows. Under this ASU, excess tax benefits or deficiencies are recognized in income tax expense in the Condensed Consolidated Statement of Earnings. Upon adoption of this ASU, the Company had a valuation allowance for its U.S. deferred tax assets and did not recognize any tax benefit. Had the Company not had a valuation allowance, the Company would have recognized a tax benefit

of \$2.4 million. The impact to the Company's dilutive shares under this new standard was immaterial.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments – Recognition and Measurement of Financial Assets and Financial Liabilities (Topic 825). This update requires that public entities measure equity investments with readily determinable fair values, at fair value, with changes in their fair value recorded through net income. This ASU also clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available for sale securities in combination with the entity's other deferred tax assets. The adoption of this standard did not have a material effect on the Company's Consolidated Financial Statements.

In July 2015, the FASB issued ASU 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory. This update simplifies the measurement of inventory valuation at the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. The adoption of this standard did not have a material effect on the Company's Consolidated Financial Statements.

In March 2016, the FASB issued ASU 2016-07, Investments – Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting. This update eliminates the requirement to retrospectively apply the equity method in previous periods when an investor obtains significant influence over an investee. The adoption of this standard did not have a material effect on the Company's Consolidated Financial Statements.

Revenue Recognition Pronouncement Currently Under Evaluation

In May 2014, the FASB issued ASU 2014-09: Revenue from Contracts with Customers (Topic 606) which supersedes virtually all existing revenue recognition guidance under U.S. GAAP. The ASU's core principle is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The update allows for the use of either the retrospective or modified retrospective approach of adoption. The update will be effective for the Company's 2019 fiscal year (July 1, 2018).

We continued our evaluation of the impact of the ASU in fiscal 2018 by evaluating its impact on selected contracts at each of our business units. As the ASU will supersede all existing revenue guidance affecting U.S. GAAP, it could impact revenue and cost recognition on our contracts across all our business units, as well as our business processes and our information technology. As a result, our evaluation of the effect of the ASU will continue through the end of fiscal year 2018. The Company has assessed its military related contracts that comprise approximately 10% of consolidated revenues. Under the ASU, based on the preliminary assessment, the Company will accelerate the recognition of revenues for certain contracts as the customer obtains control of the goods or service promised in the contract. The Company is currently evaluating the commercial portion of its business; the assessment will be completed during fiscal year 2018. Based upon our evaluation to date, we cannot currently estimate the impacts of adopting the ASU at this time. The Company will adopt this ASU using the modified retrospective method whereby the cumulative effect of applying the ASU will be recognized at the beginning of the year of adoption.

Other Pronouncements Currently Under Evaluation

In February 2018, the FASB issued ASU 2018-02, Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. The guidance permits an entity to reclassify tax effects stranded in accumulated other comprehensive income as a result of tax reform to retained earnings. The standard will be effective for the Company's 2020 fiscal year. Early adoption is permitted. The Company is evaluating the impact of this guidance on the Company's Consolidated Financial Statements.

In August 2017, the FASB issued ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities. The guidance eliminates the requirement to separately measure and report hedge ineffectiveness and generally requires the entire change in the fair value of a hedging instrument to be presented in the same income statement line as the hedged item. The standard will be effective for the Company's 2019 fiscal year. The adoption of this ASU is not expected to have a material effect on the Company's Consolidated Financial Statements.

In March 2017, the FASB issued ASU 2017-07, Compensation (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. This update affects employers' presentation of defined benefit retirement plan costs. Early adoption is permitted. The standard will be effective for the Company's 2019 fiscal year. The adoption of this ASU is not expected to have a material effect on the Company's Consolidated Financial Statements.

In January 2017, the FASB issued ASU 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business. This update changes the definition of a business to assist entities with evaluating when a set of transferred assets and activities is a business. Early adoption is permitted. The standard will be effective for the Company's 2019 fiscal year. The adoption of this ASU is not expected to have a material effect on the Company's Consolidated Financial Statements.

In October 2016, the FASB issued ASU 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory. This update requires that when intra-entity asset transfers occur, the entity must recognize tax effects

in the period in which the transfer occurs. The standard will be effective for the Company's 2019 fiscal year. Early adoption is permitted. The adoption of this ASU is not expected to have a material effect on the Company's Consolidated Financial Statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. The guidance clarifies how entities should classify certain cash receipts and cash payments on the statement of cash flows. The guidance also clarifies how the predominance principle should be applied when cash receipts and cash payments have aspects of more than one class of cash flow. The update will be effective for the Company's 2019 fiscal year. Early adoption is permitted. The Company is evaluating the impact of this guidance on the Company's Consolidated Financial Statements.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. This update is intended to provide financial statement users with more decision-useful information about expected credit losses and other commitments to extend credit held by the reporting entity. The standard replaces the incurred loss impairment methodology in current GAAP with one that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The update will be effective for the Company's 2021 fiscal

year. Early adoption is permitted. The Company is evaluating the impact of this guidance on the Company's Consolidated Financial Statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). This update requires that a lessee recognize leased assets with terms greater than 12 months on the balance sheet for the rights and obligations created by those leases. The standard will be effective for the Company's 2020 fiscal year. Early adoption is permitted. The Company is evaluating the impact of this guidance on the Company's Consolidated Financial Statements.

Note 3. Acquisitions and Investment CoAdna, Inc.

In March 2018, the Company announced its intention to acquire CoAdna, Inc. ("CoAdna"), a publically traded company on the Taiwan Stock Exchange and based in Sunnyvale, CA, in a cash transaction valued at approximately \$85.0 million net of any cash acquired. The transaction is expected to close during the first quarter of fiscal year 2019 and is subject to the approval of CoAdna's shareholders, regulatory approvals and customary closing conditions.

Purchase of Equity Investment

In November 2017, the Company acquired a 93.8% equity investment in a privately-held company for \$51.5 million. In addition, during the quarter ended March 31, 2018, the Company paid \$0.2 million for a working capital adjustment to that purchase price. The Company's pro-rata share of earnings from this investment since the acquisition date was \$0.8 million and \$2.0 million, for the three and nine months ended March 31, 2018, respectively, and was recorded in other expense (income), net in the Condensed Consolidated Statements of Earnings.

This nonconsolidated investment is accounted for under the equity method of accounting ("Equity Investment"). The following table summarizes the Company's equity in the nonconsolidated investment:

Location	Interest Type	Ownership % as of March 31, 2018	Equity as of March 31, 2018 (\$000)
USA	Equity Investment	93.80%	\$ 55,841

The Equity Investment has been determined to be a variable interest entity because the Company has an overall 93.8% economic position in the investee comprising a significant portion of its capitalization, but has only a 25% voting interest. The Company's obligation to receive rewards and absorb expected losses is disproportionate to its voting interest. The Company is not the primary beneficiary because it does not have the power to direct the activities of the equity investment that most significantly impact its economic performance. Certain business decisions, including, but not limited to, decisions with respect to operating budgets, material capital expenditures, indebtedness, significant acquisitions or dispositions, and strategic decisions, require the approval of owners holding a majority percentage in the Equity Investment. Beginning on the date it was acquired, the Company accounted for its interest as an equity method investment as the Company has the ability to exercise significant influence over operating and financial

policies of the Equity Investment.

As of March 31, 2018, the Company's maximum financial statement exposure related to the Equity Investment was approximately \$55.8 million, which is included in the investments balance on the Condensed Consolidated Balance Sheet as of March 31, 2018.

The Company has the right to purchase all of the outstanding interest of each of the minority equity holders and the minority equity holders have the right to cause the Company to purchase all of their outstanding interests at any time on or after the third anniversary of the investment or earlier upon certain events. The purchase price is equal to the greater of: (a) (i) the product of the aggregate trailing 12-month revenues of the investment preceding the date of purchase, multiplied by (ii) a factor of 2.9 multiplied by (iii) a factor of 0.723, multiplied by (iv) the percentage interest owned by each minority equity holder and (b) \$966,666. The Company performed a Monte Carlo simulation to estimate the fair value of the net put option at the investment date and recorded a liability of \$2.2 million in other long-term liabilities in the Condensed Consolidated Balance Sheet at the acquisition date in accordance with ASC 815-10, Derivatives and Hedging. The fair value of the net put option is adjusted as necessary on a quarterly basis with any changes in the fair value recorded through earnings. The change in fair value of the net purchase option from the investment date to March 31, 2018 was not material.

Kaiam Laser Limited, Inc.

In August 2017, the Company acquired Kaiam Laser Limited, Inc. (“Kaiam”), a privately held company based in Newton Aycliffe, United Kingdom. Under the terms of the merger agreement, the consideration consisted of cash paid at the acquisition date of \$79.5 million, net of cash acquired and an adjustment for a purchase price reduction recorded during the quarter ended March 31, 2018 of \$0.5 million. The acquisition of Kaiam provides the Company with a 150mm wafer fabrication platform to significantly expand the Company’s capacity for the production of vertical cavity surface emitting lasers (“VCSELs”) for the 3D sensing market and broadens the capability to address new market opportunities in other compound semiconductor materials. Kaiam now operates under the name II-VI Compound Semiconductor Ltd. within the Company’s II-VI Laser Solutions operating segment. Due to the timing of the acquisition, the Company is still in the process of measuring the fair value of assets acquired, including tangible, intangible assets and related deferred income taxes.

The following table presents the preliminary allocation of the purchase price of the assets acquired and liabilities assumed at the date of acquisition, as the Company intends to finalize its accounting for the acquisition of II-VI Compound Semiconductor Ltd. within one year from the date of acquisition (\$000):

Assets	
Accounts receivable	\$79
Inventories	4,559
Prepaid and other assets	1,246
Property, plant & equipment	63,899
Intangible assets	4,046
Goodwill	19,198
Total assets acquired	\$93,027
Liabilities	
Accounts payable	\$751
Other accrued liabilities	2,486
Deferred tax liabilities	10,797
Total liabilities assumed	14,034
Net assets acquired	\$78,993

The goodwill of \$19.2 million is included in the II-VI Laser Solutions segment and is attributed to the expected synergies and the assembled workforce of II-VI Compound Semiconductor Ltd. None of the goodwill is deductible for income tax purposes. The Company expensed transaction costs of \$0.6 million for the nine months ended March 31, 2018.

The amount of revenues of II-VI Compound Semiconductor Ltd. included in the Company’s Consolidated Statements of Earnings for the three and nine months ended March 31, 2018 was \$0.9 million and \$2.5 million, respectively. The amount of net losses of II-VI Compound Semiconductor Ltd. included in the Company’s Condensed Consolidated Statements of Earnings for the three and nine months ended March 31, 2018 was \$4.5 million and \$10.7 million, respectively.

Integrated Photonics, Inc.

In June 2017, the Company acquired Integrated Photonics, Inc. (“IPI”), a privately held company based in New Jersey. IPI is a leader in engineered magneto-optic materials that enable high-performance directional components such as optical isolators for the optical communications market. Under the terms of the merger agreement, the consideration consisted of initial cash paid at the acquisition date of \$40.1 million, net of cash acquired and a final working capital adjustment of \$0.8 million. In addition, the agreement provides up to a maximum of \$2.5 million of additional cash earnout opportunities based upon IPI achieving certain agreed upon financial and transitional objectives, which if earned would be payable in the amount of \$2.5 million for the achievement of the annual target.

The following table presents the preliminary purchase price at the date of acquisition (\$000):

Net cash paid at acquisition	\$40,098
Working capital adjustment	848
Fair value of cash earnout arrangement	2,215
Purchase price	\$43,161

The following table presents the preliminary allocation of the purchase price of the assets acquired and liabilities assumed at the date of acquisition, as the Company intends to finalize its accounting for the valuation of property, plant and equipment, identifiable intangibles and deferred income tax liabilities and anticipates completion of the valuation within one year from the date of the acquisition (\$000):

Assets	
Accounts receivable	\$2,083
Inventories	3,968
Prepaid and other assets	322
Property, plant & equipment	11,235
Intangible assets	23,554
Goodwill	17,514
Total assets acquired	\$58,676
Liabilities	
Accounts payable	\$847
Other accrued liabilities	1,032
Long-term debt assumed	3,834
Deferred tax liabilities	9,802
Total liabilities assumed	15,515
Net assets acquired	\$43,161

The goodwill of \$17.5 million is included in the II-VI Photonics segment and is attributed to the expected synergies and the assembled workforce of IPI. None of the goodwill is deductible for income tax purposes. The fair value of accounts receivable acquired was \$2.1 million with the gross contractual amount being \$2.1 million. At the time of acquisition, the Company expected to collect all of the accounts receivable. The Company expensed transaction costs of \$0.3 million all within the year ended June 30, 2017.

The amount of revenues of IPI included in the Company's Condensed Consolidated Statements of Earnings for the three and nine months ended March 31, 2018 was \$4.9 million and \$15.2 million, respectively. The amount of net earnings of IPI included in the Company's Consolidated Statements of Earnings for the three and nine months ended March 31, 2018 was \$1.1 million and \$2.5 million, respectively.

Note 4. Inventories

The components of inventories were as follows (\$000):

	March 31, 2018	June 30, 2017
Raw materials	\$90,752	\$78,979

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Work in progress	93,614	61,679
Finished goods	65,182	63,037
	\$249,548	\$203,695

Note 5. Property, Plant and Equipment

Property, plant and equipment consists of the following (\$000):

	March 31, 2018	June 30, 2017
Land and improvements	\$9,445	\$5,667
Buildings and improvements	217,300	144,293
Machinery and equipment	598,108	492,042
Construction in progress	91,184	88,458
	916,037	730,460
Less accumulated depreciation	(408,347)	(362,732)
	\$507,690	\$367,728

Note 6. Goodwill and Other Intangible Assets

Changes in the carrying amount of goodwill were as follows (\$000):

	Nine Months Ended March 31, 2018			
	II-VI		II-VI	
	Laser Solutions	II-VI Photonics	Performance Products	Total
Balance-beginning of period	\$84,180	\$113,272	\$52,890	\$250,342
Goodwill acquired	19,198	-	-	19,198
Goodwill adjustment for prior year acquisition - IPI	-	407	-	407
Foreign currency translation	2,235	2,334	-	4,569
Balance-end of period	\$105,613	\$116,013	\$52,890	\$274,516

The gross carrying amount and accumulated amortization of the Company's intangible assets other than goodwill as of March 31, 2018 and June 30, 2017 were as follows (\$000):

	March 31, 2018			June 30, 2017		
	Gross Carrying Amount	Accumulated Amortization	Net Book Value	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Technology and Patents	\$67,339	\$ (32,349)	\$34,990	\$65,438	\$ (27,313)	\$38,125
Trademarks	16,051	(1,438)	14,613	15,806	(1,340)	14,466
Customer Lists	128,399	(48,882)	79,517	123,058	(41,740)	81,318
Other	1,579	(1,557)	22	1,571	(1,523)	48
Total	\$213,368	\$ (84,226)	\$129,142	\$205,873	\$ (71,916)	\$133,957

Amortization expense recorded on the Company's intangible assets was \$3.6 million and \$11.0 million for the three and nine months ended March 31, 2018, respectively, and was \$3.1 million and \$9.5 million for the three and nine months ended March 31, 2017, respectively.

In conjunction with the acquisition of II-VI Compound Semiconductors Ltd., the Company recorded \$0.4 million attributed to the value of technology and patents and \$3.6 million of customer lists. The intangibles were recorded based on the Company's preliminary purchase price allocation utilizing either a discounted cash flow or relief from royalty method to derive the fair value. The valuation is expected to be finalized within one year from the date of acquisition.

Technology and patents are being amortized over a range of 60 to 240 months, with a weighted average remaining life of approximately 93 months. Customer lists are being amortized over a range of approximately 120 to 240 months with a weighted average remaining life of approximately 142 months. The gross carrying amount of trademarks includes \$14.3 million of acquired trade names with indefinite lives that are not amortized but tested annually for impairment or more frequently if a triggering event occurs. Included in the gross carrying amount and accumulated amortization of the Company's intangible assets is the effect of foreign currency translation on that portion of the intangible assets relating to the Company's German, U.K. and Chinese subsidiaries.

At March 31, 2018, the estimated amortization expense for the existing intangible assets for each of the five succeeding fiscal years is as follows (\$000):

Fiscal Year Ending June 30,	Amount
Remaining 2018	\$3,500
2019	14,000
2020	13,000
2021	12,300
2022	10,900

Note 7. Debt

The components of debt for the periods indicated were as follows (\$000):

	March 31, 2018	June 30, 2017
0.25% Convertible senior notes	\$345,000	\$-
Convertible senior notes unamortized discount attributable to cash conversion option and debt issuance costs including initial purchaser discount	(59,450)	-
Term loan, interest at LIBOR, as defined, plus 1.75% and 1.50%, respectively	70,000	85,000
Line of credit, interest at LIBOR, as defined, plus 1.75% and 1.50%, respectively	90,000	252,000
Credit facility unamortized debt issuance costs	(1,217)	(1,491)
Yen denominated line of credit, interest at LIBOR, as defined, plus 1.75%	2,825	2,679
Note payable assumed in IPI acquisition	3,834	3,834
Total debt	450,992	342,022
Current portion of long-term debt	(20,000)	(20,000)
Long-term debt, less current portion	\$430,992	\$322,022

0.25% Convertible Senior Notes

On August 24, 2017, the Company entered into a purchase agreement with Merrill Lynch, Pierce, Fenner & Smith Incorporated, as representative of the several initial purchasers named therein (collectively, the "Initial Purchasers"), to issue and sell \$300 million aggregate principal amount of our 0.25% convertible senior notes due 2022 (the "Notes") in a private placement to qualified institutional buyers within the meaning of Rule 144A under the Securities Act of 1933, as amended. In addition, we granted the Initial Purchasers a 30-day option to purchase up to an additional \$45

million aggregate principal amount of the Notes (the “Over-Allotment Option”).

On August 29, 2017, the Initial Purchasers exercised their Over-Allotment Option to purchase the entire \$45 million in aggregate principal amount of additional Notes. The Notes mature on September 1, 2022, unless earlier repurchased by the Company or converted by holders in accordance with the terms of the Notes. Interest is payable semi-annually in arrears on March 1 and September 1 of each year, beginning on March 1, 2018.

The sale of the Notes to the Initial Purchasers settled on August 29, 2017, and resulted in approximately \$336 million in net proceeds to the Company after deducting the initial purchasers’ discount and the estimated offering expenses. The net proceeds from the offering and sale of the Notes were used, in part, to repurchase approximately \$49.9 million of our Common Stock. The Company used the remaining net proceeds to repay \$252 million on its revolving credit facility and to pay debt issuance costs of \$10.1 million.

The Notes are governed by an Indenture between the Company, as issuer, and U.S. Bank, National Association, as trustee. The Notes are our senior unsecured obligations and rank senior in right of payment to any of our indebtedness that is expressly subordinated in right of payment to the Notes equal in right of payment to any of our indebtedness that is not so subordinated effectively junior in right of payment to any of our secured indebtedness to the extent of the value of the assets securing such indebtedness and structurally junior to all indebtedness and other liabilities (including trade payables) of our subsidiaries. In the event of our bankruptcy, liquidation, reorganization or other winding up, our assets that secure secured debt will be available to pay obligations on the Notes only after all indebtedness under such secured debt has been repaid in full from such assets. Upon conversion, the Company will pay or deliver, as the case may be, cash, shares of our Common Stock or a combination of cash and shares of our Common Stock, at the Company's election.

As a result of our cash conversion option, the Company separately accounted for the value of the embedded conversion option as a debt discount. The value of the embedded conversion option was determined based on the estimated fair value of the debt without the conversion feature, which was determined using an expected present value technique (income approach) to estimate the fair value of similar nonconvertible debt the debt discount is being amortized as additional non-cash interest expense over the term of the Notes using the effective interest method with an effective interest rate of 4.5% per annum.

The equity component is not remeasured as long as it continues to meet the conditions for equity classification. The initial conversion rate is 21.25 shares of Common Stock per \$1,000 principal amount of Notes, which is equivalent to an initial conversion price of \$47.06 per share of Common Stock. Throughout the term of the Notes, the conversion rate may be adjusted upon the occurrence of certain events.

Holders of the Notes will not receive any cash payment representing accrued and unpaid interest upon conversion of a note. Accrued but unpaid interest will be deemed to be paid in full upon conversion rather than cancelled, extinguished or forfeited.

Prior to the close of business on the business day immediately preceding June 1, 2022, the Notes will be convertible only upon satisfaction of at least one of the conditions as follows:

- a) During any fiscal quarter (and only during such fiscal quarter), if the last reported sale price of our Common Stock for at least 20 trading days (whether or not consecutive) during a period of 30 consecutive trading days ending on the last trading day of the immediately preceding quarter is greater than or equal to 130% of the conversion price on each applicable trading day
- b) During the five business day period after any five consecutive trading day period (the "measurement period") in which the trading price per \$1,000 principal amount of Notes for each trading day of the measurement period was less than 98% of the product of the last reported sale price of our Common Stock and the conversion rate on each such trading day or
- c) Upon the occurrence of specified corporate events.

On or after June 1, 2022 until the close of business on the business day immediately preceding the maturity date, holders may convert all or any portion of their Notes, in multiples of \$1,000 principal amount, at the option of the holder regardless of the foregoing circumstances.

As of March 31, 2018, the Notes are not yet convertible. The Notes will become convertible upon the satisfaction of at least one of the above conditions. In accounting for the transaction costs related to the Note issuance, the Company allocated the total amount of offering costs incurred to the debt and equity components based on their relative values. Offering costs attributable to the debt component, totaling \$8.4 million, are being amortized as non-cash interest expense over the term of the Notes, and offering costs attributable to the equity component, totaling \$1.7 million, were recorded within Shareholders' equity.

The following table sets forth total interest expense recognized related to the Notes for the three and nine months ended March 31, 2018:

	Three Months Ended March 31, 2018	Nine Months Ended March 31, 2018
0.25% contractual coupon	\$ 216	\$ 513
Amortization of debt discount and debt issuance costs including		
initial purchaser discount	2,974	7,017
Interest expense	\$ 3,190	\$ 7,530

Amended Credit Facility

On July 28, 2016, the Company amended and restated its existing credit agreement. The Third Amended and Restated Credit Agreement (the “Amended Credit Facility”) provides for a revolving credit facility of \$325 million, as well as a \$100 million term loan. The term loan is being repaid in consecutive quarterly principal payments on the first business day of each January, April, July and October, with the first payment having commenced on October 1, 2016, as follows: (i) twenty consecutive quarterly installments of \$5 million and (ii) a final installment of all remaining principal due and payable on the maturity date of July 27, 2021. Amounts borrowed under the revolving credit facility are due and payable on the maturity date. The Amended Credit Facility is unsecured, but is guaranteed by each existing and subsequently acquired or organized wholly-owned domestic subsidiary of the Company. The Company has the option to request an increase to the size of the revolving credit facility in an aggregate additional amount not to exceed \$100 million. The Amended Credit Facility has a five-year term through July 27, 2021 and has an interest rate of either a Base Rate Option or a Euro-Rate Option, plus an Applicable Margin, as defined in the agreement governing the Amended Credit Facility. If the Base Rate option is selected for a borrowing, the Applicable Margin is 0.00% to 1.25% and if the Euro-Rate Option is selected for a borrowing, the Applicable Margin is 1.00% to 2.25%. The Applicable Margin is based on the ratio of the Company’s consolidated indebtedness to consolidated EBITDA. Additionally, the Credit Facility is subject to certain covenants, including those relating to minimum interest coverage and maximum leverage ratios. As of March 31, 2018, the Company was in compliance with all financial covenants under its Amended Credit Facility.

Yen Loan

The Company’s Yen denominated line of credit is a 500 million Yen (approximately \$4.7 million) facility. The Yen line of credit matures in August 2020. The interest rate is equal to LIBOR, as defined in the loan agreement, plus 0.625% to 1.75%. At March 31, 2018 and June 30, 2017, the Company had 300 million Yen borrowed. Additionally, the facility is subject to certain covenants, including those relating to minimum interest coverage and maximum leverage ratios. As of March 31, 2018, the Company was in compliance with all financial covenants under its Yen facility.

Note Payable

In conjunction with the acquisition of IPI, the Company assumed a non-interest bearing note payable owed to a major customer of IPI. The agreement if not terminated early by either party is payable in full in May 2019.

Aggregate Availability

The Company had aggregate availability of \$236.4 million and \$73.5 million under its lines of credit as of March 31, 2018 and June 30, 2017, respectively. The amounts available under the Company’s lines of credit are reduced by outstanding letters of credit. The total outstanding letters of credit supported by these credit facilities were \$0.4 million and \$1.2 million as of March 31, 2018 and June 30, 2017, respectively.

Weighted Average Interest Rate

The weighted average interest rate of total borrowings was 1.4% and 2.3% for the nine months ended March 31, 2018 and 2017, respectively.

Remaining Annual Principal Payments

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Remaining annual principal payments under the Company's existing credit obligations from March 31, 2018 were as follows:

		Yen	U.S. Dollar	Note	Convertible	
Period	Term Loan	Line of Credit	Line of Credit	Payable	Notes	Total
Year 1	\$20,000	\$-	\$-	\$-	\$-	\$20,000
Year 2	20,000	-	-	3,834	-	23,834
Year 3	20,000	2,825	-	-	-	22,825
Year 4	10,000	-	90,000	-	-	100,000
Year 5	-	-	-	-	345,000	345,000
Total	\$70,000	\$2,825	\$90,000	\$3,834	\$345,000	\$511,659

Note 8. Income Taxes

The Company's year-to-date effective income tax rate at March 31, 2018 and 2017 was 30.9% and 26.3%, respectively. The variations between the Company's effective tax rate and the U.S. statutory blended rate of 28% for our fiscal year ending June 30, 2018 were primarily due to the impact of the U.S. enacted tax legislation and earnings generated from the Company's foreign operations, which are subject to income taxes at lower statutory rates.

U.S. GAAP prescribes the accounting for uncertainty in income taxes recognized in an enterprise's financial statements which includes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. As of March 31, 2018 and June 30, 2017, the Company's gross unrecognized income tax benefit was \$8.9 million and \$7.6 million, respectively. The Company has classified the uncertain tax positions as noncurrent income tax liabilities, as the amounts are not expected to be paid within one year. If recognized, \$5.8 million of the gross unrecognized tax benefits at March 31, 2018 would impact the effective tax rate. The Company recognizes interest and penalties related to uncertain tax positions in the income tax provision on the Condensed Consolidated Statements of Earnings. The amount of accrued interest and penalties included in the gross unrecognized income tax benefit was \$0.5 million and \$0.3 million, at March 31, 2018 and June 30, 2017, respectively. Fiscal years 2014 to 2018 remain open to examination by the United States Internal Revenue Service, fiscal years 2012 to 2018 remain open to examination by certain state jurisdictions, and fiscal years 2006 to 2018 remain open to examination by certain foreign taxing jurisdictions. The Company has been notified of upcoming examinations of the U.S. Federal income tax return for the year ended June 30, 2016 and the Switzerland Federal income tax returns for the years ended June 30, 2015 and 2016. The Company believes its income tax reserves for these tax matters are adequate.

U.S. Tax Reform

On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the "Tax Act"). The Tax Act significantly revises the future ongoing U.S. corporate income tax by, among other things, lowering U.S. corporate income tax rates and implementing a territorial tax system. As the Company has a June 30 fiscal year-end, the lower corporate income tax rate will be phased in, resulting in a U.S. statutory federal rate of approximately 28% for the Company's fiscal year ending June 30, 2018, and 21% for subsequent fiscal years. As part of the transition to the new territorial tax system, the Tax Act imposes a one-time repatriation tax on total post-1986 earnings and profits ("E&P") of foreign subsidiaries that were previously deferred from U.S. income taxes.

At March 31, 2018, the Company has not finalized its accounting for the tax effects of the Tax Act; however, as described below, management has made a reasonable estimate of the effects on existing deferred tax balances and has recorded an estimated amount for its one-time repatriation tax, resulting in an increase in income tax expense. The Company has yet to complete its calculation of the total post-1986 foreign E&P. Further, the one-time repatriation tax is based in part on the amount of those earnings held in cash and other specified assets and could be impacted by the balance of those assets at June 30, 2018, which is not yet known. This amount may change when the Company finalizes the calculation of post-1986 foreign E&P previously deferred from U.S. taxation and the amounts held in cash or other specified assets as of June 30, 2018 are known.

The impact of the repatriation tax is expected to be offset by available net operating loss and credit carryforwards which currently have a valuation allowance. Thus, the tax expense reported is reduced by the release of the valuation allowance on U.S. deferred tax assets. The reduction of the U.S. corporate tax rate caused the Company to adjust the

U.S. deferred tax assets and liabilities to the lower U.S. statutory federal rate of 21%. However, the Company will continue to analyze certain aspects of the Tax Act which could affect the measurement of these balances or give rise to new deferred tax amounts. In addition, the Company has recorded withholding taxes on planned repatriation due to the change to a territorial tax system. The \$6.5 million income tax benefit recorded during the quarter ended March 31, 2018 for Tax Act was related to a change in the mix of forecasted income between U.S. and foreign sources for fiscal year 2018 resulting in a higher benefit for U.S. valuation allowance release being attributed to the Tax Act. The transitional impacts described above resulted in a cumulative provisional net charge of \$9.3 million for the year to date March 31, 2018.

The changes included in the Tax Act are broad and complex. The final transition impacts of the Tax Act may differ from the estimates recorded through March 31, 2018, possibly materially, due to, among other things, changes in interpretations of the Tax Act, any legislative action to address questions that arise because of the Tax Act, any changes in accounting standards for income taxes or related interpretations in response to the Tax Act, or any updates or changes to estimates the Company has utilized to calculate the transition impacts, including impacts from changes to current year earnings estimates and foreign exchange rates of foreign subsidiaries. The Securities Exchange Commission has issued rules that allow for a measurement period of up to one year after the enactment date of the Tax Act to finalize the recording of the related tax impacts. The Company currently anticipates finalizing and recording any resulting adjustments by the end of the quarter ending December 31, 2018.

Note 9. Earnings Per Share

The following table sets forth the computation of earnings per share for the periods indicated. Basic net income per share has been computed using the weighted average number of shares of common stock outstanding during the period. Diluted net income per share has been computed using the weighted average number of common shares outstanding during the period plus dilutive potential shares of common stock from (1) stock options, performance and restricted shares (under the treasury stock method) and (2) convertible debt (under the If Converted method) outstanding during the period. (\$000 except per share data):

	Three Months Ended March 31, 2018		Nine Months Ended March 31, 2017	
Numerator:				
Net earnings	\$30,098	\$22,430	\$60,835	\$62,627
Numerator for basic income per share	\$30,098	\$22,430	\$60,835	\$62,627
Effect of dilutive securities:				
Interest expense, net of tax, on 0.25% Convertible Senior Notes due 2022	2,520	-	-	-
Numerator for diluted income per share	\$32,618	\$22,430	\$60,835	\$62,627
Denominator:				
Denominator for basic income per share - weighted average shares	62,427	62,807	62,491	62,403
Effect of dilutive securities:				
Dilutive effect of common stock equivalents	2,624	2,203	2,633	1,930
0.25% Convertible Senior Notes due 2022	7,331	-	-	-
Dilutive potential common shares	9,955	2,203	2,633	1,930
Denominator for diluted income per share	72,382	65,010	65,124	64,333
Net earnings per share:				
Basic earnings per common share	\$0.48	\$0.36	\$0.97	\$1.00
Diluted earnings per common share	\$0.45	\$0.35	\$0.93	\$0.97

The following table presents potential shares of common stock excluded from the calculation of diluted net income per share as their effect would have been anti-dilutive (\$000):

	Three Months Ended March 31, 2018		Nine Months Ended March 31, 2017	
Stock options and restricted shares	199	36	140	163
0.25% Convertible Senior Notes due 2022	-	-	7,331	-
Total anti-dilutive shares	199	36	7,471	163

Note 10. Segment Reporting

The Company reports its business segments using the “management approach” model for segment reporting. This means that the Company determines its reportable business segments based on the way the chief operating decision maker organizes business segments within the Company for making operating decisions and assessing performance.

The Company reports its financial results in the following three segments: (i) II-VI Laser Solutions, (ii) II-VI Photonics, and (iii) II-VI Performance Products, and the Company’s chief operating decision maker receives and reviews financial information based on these segments. The Company evaluates business segment performance based upon segment operating income, which is defined as earnings before income taxes, interest and other income or expense. The segments are managed separately due to the market, production requirements and facilities unique to each segment.

In June 2017, the Company completed its acquisition of IPI. See Note 3. Acquisitions and Investment. The operating results of this acquisition have been reflected in the selected financial information of the Company’s II-VI Photonics segment since the date of acquisition.

In August 2017, the Company completed its acquisition of II-VI Compound Semiconductor Ltd. See Note 3. Acquisitions and Investment. The operating results of this acquisition have been reflected in the selected financial information of the Company's II-VI Laser Solutions segment since the date of acquisition.

The accounting policies are consistent across each of the segments. The Company's corporate expenses and assets are allocated to the segments. The Company evaluates segment performance based upon reported segment operating income, which is defined as earnings before income taxes, interest and other income or expense. Inter-segment sales and transfers are eliminated.

The following tables summarize selected financial information of the Company's operations by segment (\$000):

	Three Months Ended March 31, 2018				
	II-VI Laser Solutions	II-VI Photonics	II-VI Performance Products	Eliminations	Total
Revenues	\$ 109,796	\$ 116,778	\$ 68,172	\$ -	\$ 294,746
Inter-segment revenues	8,256	(501)	1,707	(9,462)	-
Operating income	9,932	16,637	8,169	-	34,738
Interest expense	-	-	-	-	(5,014)
Other income (expense), net	-	-	-	-	1,496
Income taxes	-	-	-	-	(1,122)
Net earnings	-	-	-	-	-