II-VI INC
Form 10-Q
May 09, 2007
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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 2007

¨ **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 incorporation or organization)	**(I.R.S. Employer 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)

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 x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

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

At May 4, 2007, 29,547,547 shares of Common Stock, no par value, of the registrant were outstanding.

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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, 2007	June 30, 2006
Assets		
Current Assets		
Cash and cash equivalents	$ 26,048	$ 26,885
Accounts receivable less allowance for doubtful accounts of $1,134 at March 31, 2007 and $1,114 at June 30, 2006	45,446	42,122
Inventories	54,877	48,454
Deferred income taxes	9,186	7,561
Prepaid and other current assets	3,333	2,611
Total Current Assets	138,890	127,633
Property, plant & equipment, net	81,648	77,713
Goodwill	24,801	23,293
Other intangible assets, net	14,263	14,968
Investment	3,042	2,437
Other assets	4,876	4,252
Total Assets	$ 267,520	$ 250,296
Current Liabilities		
Accounts payable	$ 13,039	$ 9,540
Accrued salaries and wages	5,112	4,725
Accrued bonuses	6,629	6,923
Income taxes payable	4,877	6,164
Accrued profit sharing contribution	2,080	2,561
Deferred revenue		2,572
Other accrued liabilities	6,394	4,997
Current portion of long-term debt	2,607	7,553
Total Current Liabilities	40,738	45,035
Long-term debt	11,708	23,614
Deferred income taxes	5,673	8,119
Other liabilities	4,758	2,937
Total Liabilities	62,877	79,705
Commitments and Contingencies		
Shareholders Equity		
Preferred stock, no par value; authorized 5,000,000 shares; none issued		
Common stock, no par value; authorized 100,000,000 shares; issued 32,020,984 shares at March 31, 2007; 31,628,368 shares at June 30, 2006	65,079	57,431
Accumulated other comprehensive income	1,043	742
Retained earnings	146,978	120,321

	213,100	178,494
Less treasury stock, at cost, 2,508,807 shares at March 31, 2007 and 2,486,608 shares at June 30, 2006	8,457	7,903
Total Shareholders Equity	204,643	170,591
Total Liabilities and Shareholders Equity	$ 267,520	$ 250,296

- See notes to condensed consolidated financial statements.

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II-VI Incorporated and Subsidiaries

Condensed Consolidated Statements of Earnings (Unaudited)

($000 except per share data)

	Three Months Ended March 31, 2007	2006
Revenues		
Net sales:		
Domestic	$ 34,506	$ 31,576
International	28,784	25,066
	63,290	56,642
Contract research and development	3,795	2,721
Total Revenues	67,085	59,363
Costs, Expenses & Other (Income)		
Cost of goods sold	36,224	32,960
Contract research and development	2,741	2,095
Internal research and development	1,614	1,604
Selling, general and administrative	14,359	11,212
Interest expense	204	458
Other (income), net	(518)	(164)
Total Costs, Expenses and Other (Income)	54,624	48,165
Earnings Before Income Taxes	12,461	11,198
Income Taxes	2,412	3,748
Net Earnings	$ 10,049	$ 7,450
Basic Earnings Per Share	$ 0.34	$ 0.25
Diluted Earnings Per Share	$ 0.33	$ 0.25

- See notes to condensed consolidated financial statements.

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II-VI Incorporated and Subsidiaries

Condensed Consolidated Statements of Earnings (Unaudited)

($000 except per share data)

	Nine Months Ended March 31, 2007	Nine Months Ended March 31, 2006
Revenues		
Net sales:		
Domestic	$ 98,834	$ 92,705
International	83,505	67,894
	182,339	160,599
Contract research and development	8,885	6,982
Total Revenues	191,224	167,581
Costs, Expenses & Other (Income)		
Cost of goods sold	104,078	95,677
Contract research and development	6,643	5,052
Internal research and development	4,476	5,481
Selling, general and administrative	41,592	34,012
Interest expense	873	1,313
Other (income), net	(1,963)	(1,562)
Total Costs, Expenses and Other (Income)	155,699	139,973
Earnings Before Income Taxes	35,525	27,608
Income Taxes	8,868	8,229
Net Earnings	$ 26,657	$ 19,379
Basic Earnings Per Share	$ 0.91	$ 0.66
Diluted Earnings Per Share	$ 0.88	$ 0.65

- See notes to condensed consolidated financial statements.

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II-VI Incorporated and Subsidiaries

Condensed Consolidated Statements of Cash Flows (Unaudited)

($ 000)

	Nine Months Ended March 31, 2007	2006
Cash Flows from Operating Activities		
Net earnings	$ 26,657	$ 19,379
Adjustments to reconcile net earnings to net cash provided by (used in)operating activities:		
Depreciation	10,982	10,573
Amortization	1,005	874
Share-based compensation expense	2,263	1,636
Gain on foreign currency remeasurements and transactions	(350)	(639)
Net loss on disposal of assets	41	13
Deferred income taxes	(4,069)	(1,933)
Excess tax benefits from share-based compensation expense	(2,449)	
Increase (decrease) in cash from changes in:		
Accounts receivable	(2,763)	(3,232)
Inventories	(5,935)	(5,246)
Accounts payable	2,549	1,096
Deferred revenue	(2,572)	2,984
Other operating net assets	276	1,964
Net cash provided by operating activities	25,635	27,469
Cash Flows from Investing Activities		
Additions to property, plant and equipment	(13,837)	(12,684)
Proceeds from sale of property, plant and equipment	88	9
Purchase of businesses	(840)	(1,628)
Dividend from unconsolidated business	23	23
Purchase of intangible assets	(100)	
Net cash used in investing activities	(14,666)	(14,280)
Cash Flows from Financing Activities		
Proceeds on short-term borrowings		2,500
Payments on short-term borrowings	(2,000)	(8,400)
Payments on long-term borrowings	(14,790)	(1,913)
Proceeds from exercise of stock options	2,936	873
Purchase of treasury stock	(502)	(1,722)
Excess tax benefits from share-based compensation expense	2,449	
Net cash used in financing activities	(11,907)	(8,662)
Effect of exchange rate changes on cash and cash equivalents	101	(1,886)
Net (decrease) increase in cash and cash equivalents	(837)	2,641
Cash and Cash Equivalents at Beginning of Period	26,885	21,675
Cash and Cash Equivalents at End of Period	$ 26,048	$ 24,316

Non-cash transactions:		
Additions to property, plant and equipment included in accounts payable	$ 1,317	$ 648
Cash paid for interest	$ 1,186	$ 1,066
Cash paid for income taxes	$ 12,563	$ 7,543

- See notes to condensed consolidated financial statements.

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II-VI Incorporated and Subsidiaries

Condensed Consolidated Statements of Shareholders Equity (Unaudited)

(000)

	Common Stock Shares	Common Stock Amount	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock Shares	Treasury Stock Amount	Total
BALANCE JUNE 30, 2006	31,628	$ 57,431	$ 742	$ 120,321	(2,487)	$ (7,903)	$ 170,591
Shares issued under stock option plan	393	2,936					2,936
Share-based compensation expense		2,263					2,263
Net earnings				26,657			26,657
Purchase of treasury stock					(20)	(502)	(502)
Treasury stock under deferred compensation arrangements					(2)	(52)	(52)
Excess tax benefit under SFAS 123(R)		2,449					2,449
Other comprehensive income, net of tax			301				301
BALANCE MARCH 31, 2007	32,021	$ 65,079	$ 1,043	$ 146,978	(2,509)	$ (8,457)	$ 204,643

- See notes to condensed consolidated financial statements.

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II-VI Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

Note A Basis of Presentation

The condensed consolidated financial statements for the three and nine month periods ended March 31, 2007 and 2006 are unaudited. In the opinion of management, all adjustments considered necessary for a fair presentation for the periods presented have been included. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto in the Company s annual report on Form 10-K for the year ended June 30, 2006. Certain amounts from the prior year have been reclassified to conform to the current period presentation. The condensed consolidated results of operations for the three and nine month periods ended March 31, 2007 are not necessarily indicative of the results to be expected for the full year.

Note B Share-Based Compensation

The Company records share-based compensation expense pursuant to Statement of Financial Accounting Standards No. 123 (revised 2004), (SFAS 123R) Share-Based Payment. SFAS 123R requires the recognition of the fair value of share-based compensation in net earnings. The Company recognizes the share-based compensation expense over the requisite service period of the individual grantees, which generally equals the vesting period.

Under the provisions of SFAS 123R, the Company recorded $0.8 million and $2.3 million in share-based compensation expense in its Condensed Consolidated Statements of Earnings for the three and nine months ended March 31, 2007, respectively, and $0.7 million and $1.6 million for the three and nine months ended March 31, 2006, respectively. The share-based compensation expense is allocated approximately 25% to cost of goods sold and 75% to selling, general and administrative expense in the Condensed Consolidated Statements of Earnings. The Company utilized the Black-Scholes valuation model for estimating the fair value of the share-based compensation expense. During the nine months ended March 31, 2007 and 2006, the weighted-average fair value of options granted under the stock option plan was $14.60 and $10.80, respectively, per option using the following assumptions:

	Three Months Ended	Three Months Ended	Nine Months Ended	Nine Months Ended
	March 31, 2007	March 31, 2006	March 31, 2007	March 31, 2006
Risk free interest rate	4.74%	4.91%	5.15%	4.49%
Expected volatility 52 %	58%	57%	59%	
Expected life of options	6.92 years	6.36 years	6.92 years	6.36 years
Dividend yield	none	none	none	none

The risk-free interest rate is derived from the average U.S. Treasury Note rate during the period, which approximates the rate in effect at the time of grant related to the expected life of the options. The risk-free interest rate shown above is the weighted-average rate for all options granted during the periods. Expected volatility is based on the historical volatility of the Company s common stock over the period commensurate with the expected life of the options. The expected life calculation is based on the observed and expected time to post-vesting exercise and forfeitures of options by our employees. The dividend yield of zero is based on the fact the Company never paid cash dividends and has no intention to pay cash dividends in the future. The estimated annualized forfeitures are based on the Company s historical experience of option pre-vesting cancellations and are estimated at 22%. Under the provisions of SFAS 123R, the Company will record additional expense in future periods if the actual forfeiture rate is lower than estimated, and will record a recovery of prior expense if the actual forfeiture is higher than estimated.

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Effective July 1, 2006, the Company issued performance share awards under the II-VI Incorporated 2005 Omnibus Incentive Plan to certain executive officers for the performance period from July 2006 to December 2007. The awards are intended to provide continuing emphasis on specified financial performance goals that the Company considers to be important contributors to long-term shareholder value. The awards are only payable if the Company achieves specified levels of revenue and cash flows from operations for the performance period. Included in the $2.3 million share-based compensation expense for the nine months ended March 31, 2007 was $0.3 million of expense attributable to the performance share awards. The performance share awards compensation expense was calculated based on the estimated number of shares expected to be earned multiplied by the stock price at the date of grant.

Note C Acquisitions

II-VI Suisse S.a.r.l.

In January 2007, the Company exercised its call option and purchased the remaining 25% interest of II-VI Suisse S.a.r.l. for approximately $0.8 million. In connection with the purchase, the Company entered into two separate three year non-compete agreements with the sellers. The purchase price was allocated to goodwill and these non-compete agreements.

Note D Contract Receivables

The components of contract receivables, which are a component of accounts receivable, net, were as follows ($000):

	March 31, 2007	June 30, 2006
Billed		
Completed Contracts	$ 129	$ 25
Contracts in Progress	2,719	1,656
	2,848	1,681
Unbilled	3,411	2,159
	$ 6,259	$ 3,840

Note E Inventories

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

	March 31, 2007	June 30, 2006
Raw materials	$ 14,418	$ 16,120
Work in progress	21,564	17,388
Finished goods	18,895	14,946
	$ 54,877	$ 48,454

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Note F Property, Plant and Equipment

Property, plant and equipment at cost or valuation consist of the following ($000):

	March 31, 2007	June 30, 2006
Land and land improvements	$ 1,942	$ 1,884
Buildings and improvements	47,808	47,319
Machinery and equipment	100,478	97,264
Construction in progress	14,275	4,334
	164,503	150,801
Less accumulated depreciation	(82,855)	(73,088)
	$ 81,648	$ 77,713

Note G Goodwill and Intangible Assets

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

	March 31, 2007
Beginning Balance July 1, 2006	$ 23,293
Goodwill acquired II-VI Suisse S.a.r.l.	813
Income tax adjustment Marlow Industries, Inc.	625
Foreign currency translation II-VI Deutschland GmbH	70
Balance End of Period	$ 24,801

In connection with the remaining 25% acquisition of II-VI Suisse S.a.r.l. in January 2007, the Company recorded the excess purchase price over the net assets of the business acquired as goodwill in the accompanying Condensed Consolidated Balance Sheets based on the purchase price allocation.

The Company has recorded an estimated reserve for the potential disallowance of certain tax deductions taken by the Company s subsidiary, Marlow Industries, Inc. (Marlow). This reserve relates to the opening balance sheet of Marlow and did not impact current period earnings. The Company recorded this reserve as an increase in the amount of $0.6 million in goodwill.

The gross carrying amount and accumulated amortization of the Company s intangible assets other than goodwill as of March 31, 2007 and June 30, 2006 were as follows ($000):

	March 31, 2007			June 30, 2006		
	Gross Carrying Amount	Accumulated Amortization	Net Book Value	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Patents	$ 5,756	$ (2,187)	$ 3,569	$ 5,506	$ (1,777)	$ 3,729
Trademarks	7,491	(497)	6,994	7,491	(441)	7,050
Customer Lists	5,939	(2,412)	3,527	5,863	(1,973)	3,890

Other	1,377		(1,204)	173	1,348		(1,049)	299
Total	$ 20,563	$	(6,300)	$ 14,263	$ 20,208	$	(5,240)	$ 14,968

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Amortization expense recorded on the intangible assets was $0.3 million and $1.0 million, for the three and nine months ended March 31, 2007, respectively, and was $0.1 million and $0.9 million for the three and nine months ended March 31, 2006, respectively. The gross carrying amount of Trademarks includes $6.0 million of an acquired trade name with an indefinite life not amortized but tested annually for impairment. Included in the gross carrying amount and accumulated amortization of the Company s customer lists component of intangible assets and goodwill is the effect of the foreign currency translation of the portion relating to the Company s German subsidiary. At March 31, 2007, the estimated amortization expense for existing intangible assets for each of the five succeeding fiscal years is as follows:

Year Ended June 30, ($000)	
Remaining 2007	$ 374
2008	1,281
2009	1,183
2010	1,183
2011	1,133

Note H Debt

The components of debt were as follows ($000 s):

	March 31, 2007	June 30, 2006
Line of credit, interest at the LIBOR Rate, as defined, plus 0.50% and 0.75%, respectively	$ 11,500	$ 2,000
Term loan, interest at the LIBOR Rate, as defined, plus 0.75% payable in quarterly installments		26,250
Pennsylvania Industrial Development Authority (PIDA) term note, interest at 3.00%, payable in monthly installments through October 2011	262	303
Yen denominated term note, interest at the Japanese Yen Base Rate, as defined, plus 1.49%, principal payable in full in September 2011 and September 2007, respectively	2,553	2,614
Total debt	14,315	31,167
Current portion of long-term debt	(2,607)	(7,553)
Long-term debt	$ 11,708	$ 23,614

The Company replaced its existing credit facility in October 2006 with a new unsecured credit facility. The new facility is a $60.0 million line of credit which, under certain conditions, may be expanded to $100.0 million. The new credit facility has a five-year term through October 2011 and has interest rates ranging from LIBOR plus 0.50% to LIBOR plus 1.25%. Additionally, the facility is subject to certain restrictive covenants, including those relating to minimum interest coverage and maximum leverage ratios.

The weighted average interest rate of borrowings under the credit agreements was 6.0% and 4.6% for the nine months ended March 31, 2007 and 2006, respectively. The Company had available $47.8 million and $27.4 million under its lines of credit as of March 31, 2007 and June 30, 2006, respectively. The amounts available under the Company s lines of credit are reduced by outstanding letters of credit. At March 31, 2007 and June 30, 2006, total outstanding letters of credit supported by the credit facilities were $0.7 million and $0.6 million, respectively.

The Company has a 300 million Yen loan. In October 2006, the Company extended the term of the 300 million Yen loan to September 2011. Interest is at a rate equal to the Japanese Yen Base Rate, as defined in the loan agreement, plus 1.49%. The Japanese Yen Base Rate was 0.73% at March 31, 2007 and 0.16% at June 30, 2006. The Company is in the process of replacing the 300 million Yen loan with a larger Yen loan and, therefore, has classified the 300 million Yen loan in the current portion of long-term debt as of March 31, 2007. The Company expects the 300 million Yen loan to be replaced on or before June 30, 2007.

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Note I Earnings Per Share

The following table sets forth the computation of earnings per share for the periods indicated. Weighted average shares issuable upon the exercise of stock options that were not included in the calculation because they were antidilutive were immaterial for all periods presented (000 except per share data):

	Three Months Ended		Nine Months Ended	
	March 31,		March 31,	
	2007	2006	2007	2006
Net earnings	$ 10,049	$ 7,450	$ 26,657	$ 19,379
Divided by:				
Weighted average shares	29,411	29,284	29,306	29,253
Basic earnings per common share	$ 0.34	$ 0.25	$ 0.91	$ 0.66
Net earnings	$ 10,049	$ 7,450	$ 26,657	$ 19,379
Divided by:				
Weighted average shares	29,411	29,284	29,306	29,253
Dilutive effect of common stock equivalents	925	647	853	699
Diluted weighted average common shares	30,336	29,931	30,159	29,952
Diluted earnings per common share	$ 0.33	$ 0.25	$ 0.88	$ 0.65

Note J Comprehensive Income

The components of comprehensive income were as follows for the periods indicated ($000):

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2007	2006	2007	2006
Net earnings	$ 10,049	$ 7,450	$ 26,657	$ 19,379
Other comprehensive income (loss):				
Foreign currency translation adjustments net of income taxes of $34 and $100, respectively, for the three and nine months ended March 31, 2007 and $103 and $(142), respectively, for the three and nine months ended March 31, 2006.	142	205	301	(334)
Comprehensive income	$ 10,191	$ 7,655	$ 26,958	$ 19,045

Note K Segment and Geographic Reporting

The Company reports its segments using the management approach model for segment reporting. The management approach model is based on the way a company s management organizes segments within the company for making operating decisions and assessing performance. Reportable segments are based on products and services, geography, legal structure, management structure or any other manner in which management segregates a company.

The Company s reportable segments offer similar products to different target markets. The segments are managed separately due to the production requirements and facilities that are unique to each segment. The Company has the following reportable segments: Infrared Optics, which is the Company s infrared optics and material products businesses and remaining corporate activities, primarily corporate assets, capital expenditures and share-based compensation; Near-Infrared Optics, which is the Company s VLOC subsidiary, the Suzhou, China and Vietnam near-infrared operations; Military Infrared Optics, which is the Company s Exotic Electro-Optics subsidiary; and the Compound Semiconductor Group, which is the aggregation of Marlow, the eV PRODUCTS division, the Wide Bandgap Materials (WBG) group and the Advanced Material Development Center (AMDC) group, (which is responsible for the corporate research and development activities).

The Infrared Optics segment is divided into geographic locations in the United States, Singapore, China, Germany, Switzerland, Japan, Belgium and the United Kingdom. An Executive Vice President of the Company directs the segment, while each geographic location is directed by a general manager, and is further divided into production and administrative units that are directed by managers. The Infrared Optics segment designs, manufactures and markets optical and electro-optical components and materials sold under the II-VI Infrared and II-VI brand names and used primarily in high-power CO_2 lasers.

The Near-Infrared Optics segment is located in the United States, China, Vietnam, Germany, Japan and the United Kingdom. The Near-Infrared Optics segment is directed by a general manager. The Near-Infrared Optics segment is further divided into production and administrative units that are directed by managers. The Near-Infrared Optics segment designs, manufactures and markets near-infrared and visible-light products for industrial, scientific, military and medical instruments and laser gain material and products for solid-state Yttrium Aluminum Garnet, Yttrium Lithium Fluoride lasers and UV filter components.

The Military Infrared Optics segment is located in the United States. The Military Infrared Optics segment is directed by a general manager with oversight by a Corporate Vice President. The Military Infrared Optics segment is further divided into production and administrative units that are directed by managers. The Military Infrared Optics segment designs, manufactures and markets infrared products for military applications under the Exotic Electro-Optics brand name.

The Compound Semiconductor Group is located in the United States, the United Kingdom, Japan, China and Vietnam. The Compound Semiconductor Group segment is directed by a Corporate Vice President. Marlow designs and manufacturer thermoelectric cooling and power generation solutions for use in defense and space, telecommunications, medical, consumer and industrial markets. The eV PRODUCTS division manufactures and markets solid-state x-ray and gamma-ray sensor materials and products for use in medical, security monitoring, industrial, environmental and scientific applications. The WBG group manufactures and markets single crystal silicon carbide substrates for use in solid-state lighting, wireless infrastructure, radio frequency (RF) electronics and power switching industries. The AMDC group directs the corporate research and development initiatives.

The accounting policies of the segments are the same as those of the Company. Substantially all of the Company s corporate expenses are allocated to the segments. The Company evaluates segment performance based upon reported segment earnings or loss, which is defined as earnings before income taxes, interest and other income or expense. Inter-segment sales and transfers have been eliminated.

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The following table summarizes selected financial information of the Company s operations by segment ($000 s):

	Three Months Ended March 31, 2007					
	Infrared Optics	Near-Infrared Optics	Military Infrared Optics	Compound Semiconductor Group	Eliminations	Total
Revenues	$ 34,000	$ 12,866	$ 7,065	$ 13,154		$ 67,085
Inter-segment revenues	169	346	89	1,810	(2,414)	
Segment earnings	8,817	1,512	966	852		12,147
Interest expense						(204)
Other income, net						518
Earnings before income taxes						12,461