Coverage Initiation: November 19, 2019

II-VI Inc.: (NASDAQ: IIVI)

Analyst: Tyler Keegan
Rating: BUY

Sector: Information Technology
Industry: Electronic Equipment
Current Price: $28.06
Target Price: $37.50
Upside Potential: 33.64%

Company Description: II-VI Incorporated develops, manufactures, and markets engineered materials, and optoelectronic components and devices worldwide.

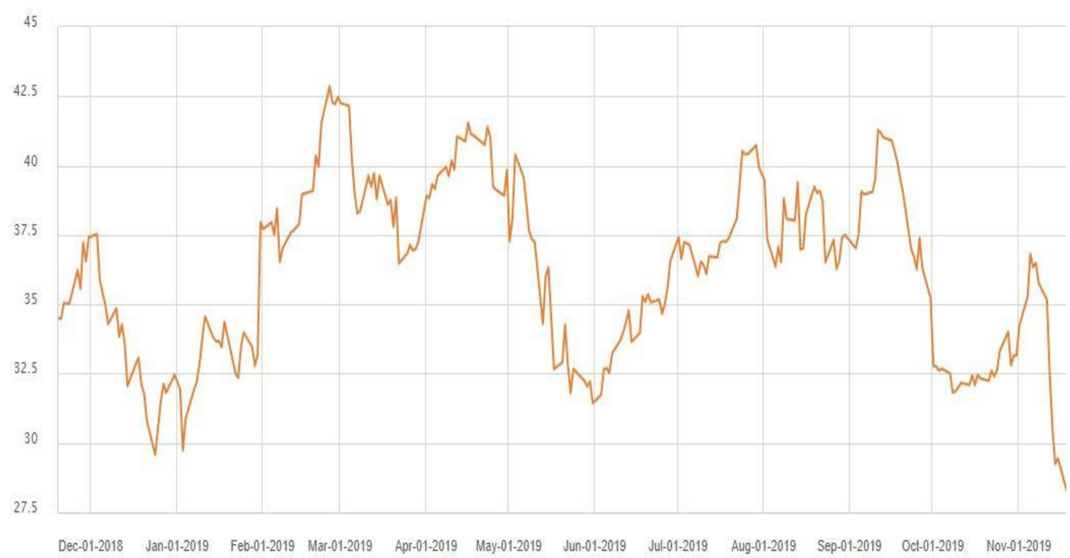
BUY

Current Price: $28.06

Target Price: $37.50

Upside Potential: 33.64%

Market Cap: $2.55B



Thesis: II-VI is broken up into three main segments: laser solutions, photonics, and performance products. II-VI should continue to see strong revenue growth from contributions from their diverse portfolio of products, which they will continue to leverage to compete and differentiate themselves in their end markets. Strong revenue growth, accompanied by strong financials, will allow them to continue to have strong earnings and value appreciation into the future.

Valuation: To value II-VI, I used a blend of discounted cash flows, and forward Price/Earnings estimates to arrive at a one-year target price of $37.50, a 33.64% premium from their 11/19 price of $28.06. Even with very conservative margin, growth, and expense assumptions, II-VI is still deeply undervalued on both a discounted cash flow and multiple valuation basis.

Catalysts for Growth

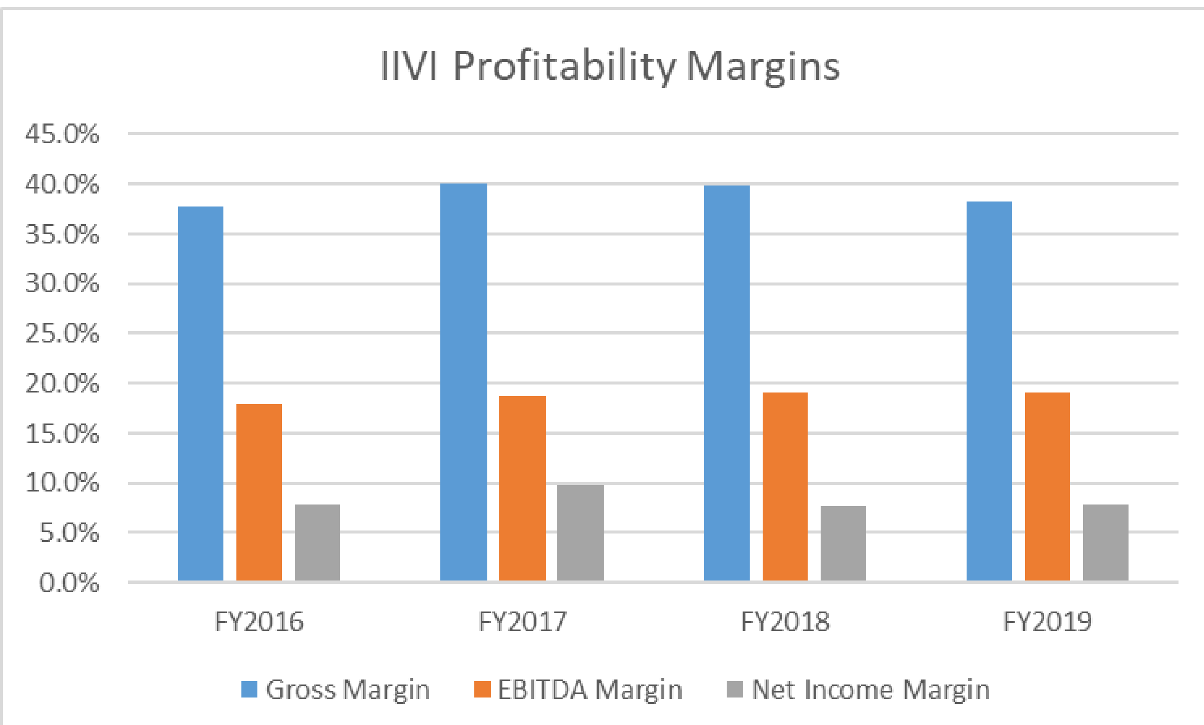
1. Strong Underlying Financials

Relative Valuation

On a relative basis, IIVI can be considered at a discount to their five year averages, and the Technology industry as a whole. They are currently trading below their five year averages, as well as industry averages, in Price/Earnings, Price/Cash Flow, and Price/Sales.

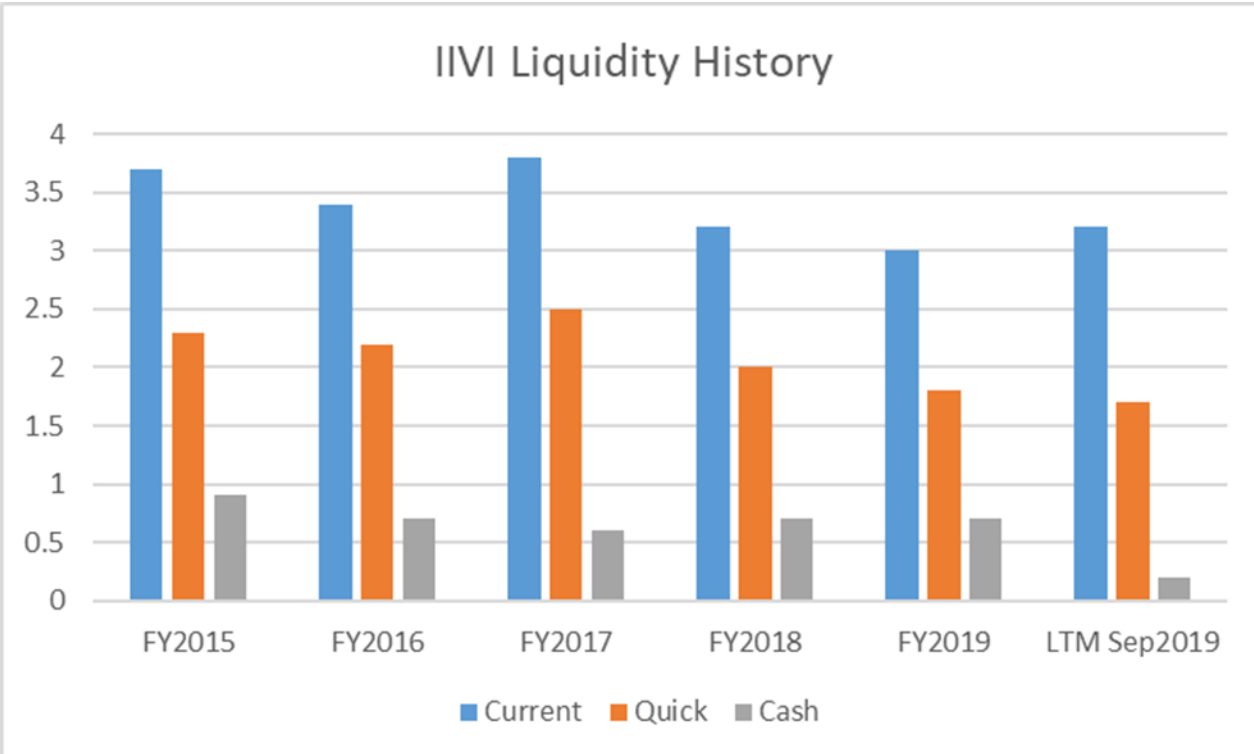
	IIVI	IIVI 5Y Avg	Industry
Price/Earnings	21.9	24.5	23.9
Price/Cash Flow	13.2	14.1	21.8
Price/Sales	1.7	1.9	3.5

Profitability Analysis



As exhibited in the above charts, IIVI's margins have been holding at very stable rates over the past 5 fiscal years. This provides great confidence that they will continue to operate efficiently, and will use their expected top-line growth well in driving future earnings.

Short-Term Liquidity is Stable



Their short-term liquidity ratios have been consistently within the same levels, suggesting they have the financial stability to meet their near-term financial needs with no foreseeable problems.

2. A Diverse Core Market to Support Top-Line Growth

Business Segments Defined

Photonics (49% of Q2FY2020 Revenue)

The photonics segment manufactures crystal materials, optics, microchip lasers, and optoelectronic modules for use in optical communications networks and other diverse consumer, life sciences, and commercial applications. In addition, the segment also manufactures pump lasers, optical isolators, optical amplifiers, and micro-optics for optical amplifiers for both terrestrial and submarine applications within the optical communications market.

Laser Solutions (24% of Q2FY2020 Revenue)

The laser solutions segment designs, manufactures, and markets optical and electro-optical components and materials sold under the II-VI infrared brand name that are used primarily in high-power CO2 lasers, fiber-delivered beam delivery systems, and processing tools.

Performance Products (27% of Q2FY2020 Revenue)

Performance Products designs, manufactures, and markets infrared optical components and high-precision optical assemblies for aerospace and defense, medical, and commercial laser imaging applications. In addition, the segment designs, manufactures, and markets unique silicon carbide engineered materials for thermoelectric devices and subsystems for SiC applications servicing the semiconductor equipment, aerospace and defense, communications, automotive, and life science markets.

Product Summary

With this suite of products, II-VI primarily ends up breaking their revenue up into commercial (88%), and government (10% from US Government).

The government segment of revenue can be viewed as stable, as II-VI manufactures essential to US military operations. Manufacturing parts for equipment used in reconnaissance, targeting, navigation, and intelligence. This portion of the US military budget is most likely going to be much less subject to political policy changes, as this equipment supports the backbone and future of military operations, and will only grow larger as demand for highly-intelligent equipment in this field grows over time to keep up with global military advancements.

Industrial laser optics and optical communications equipment are core drivers of the commercial/industrial portion of revenue, and will continue to grow in demand at a high rate as global demand for this advanced technology increases. Optical communications products are currently in use to support global 4G networks, as well as other high-speed transmission centers and data systems. Demand for this type of technology will not be slowing down anytime soon, as the race for faster networks and 5G technology will place demand for this equipment at a steady rate of growth for the foreseeable future. Laser optics are primarily used in precision machinery, such as marking and micro-drilling. The diverse portfolio of laser optics contributes to several key functions of these systems, from the beam delivery systems that direct the output optical power to the target, to a broad set of laser optics and fused fiber products that enable many functions within these systems. The portfolio of laser optics offered by II-VI covers this wide variety of demand throughout this industry, and will serve many of these growing precision laser markets for the foreseeable future.

Risks to Valuation

1. Finisar Acquisition

Ultimately, the Finisar acquisition is expected to add 7 new end markets, $22 billion in addressable market size, and thousands of new employees to II-VI's already sizeable portfolio of products and revenue. However, with any acquisition, there are some concerns that come with the merging of the two corporations. Under the acquisition, the now combined debt of both companies puts the leverage of II-VI up to 4.1x. Management's goal is to reduce this down to under 2.5x within two years, but disruptions in growth or the smooth merging of the two companies could put II-VI in a difficult position as far as solvency goes. At the moment, these have manifested themselves in their Q1 FY2020 earnings results, where II-VI saw an increase in debt, as expected by management, and a decrease in margins. This results led to a significant intraday drop in price, and present a great opportunity to get into the stock at a very cheap price. While there are valid concerns surrounding the acquisition of Finisar, management is still convinced that these are temporary growing pains due to the freshness of the acquisition on the company's financials, and that things will smooth out looking forward. However, it will be something to keep a mindful eye on going forward as an investor as far as the solvency of II-VI goes, and to see if their margins rebound accordingly.

2. Global Trade Disputes

U.S. and global trade disputes may impact II-VI's international operations and the cost of goods imported into the United States, which may narrow the size of their markets, materially impact their revenues, or increase their operating costs. These are reasonable concerns, given the nature and volatility of the current global trade market. However, these concerns are likely already priced into the market value of the stock, and these concerns and tensions will likely begin to ease over the next 12 months, as the US and China have finally begun constructive conversations regarding trade, with more news expected soon.

Investment Summary

II-VI is a financially sound, consistently meeting their short-term liquidity needs, and posting strong yearly operating and earnings margins with little or no deviations from the normal. Financial stability, the integration of new acquisitions, and a diverse portfolio of customers and products should help II-VI continue to show strong earnings appreciation, with their top-line projected to grow at sizeable rates over the next several years. Even with conservative earnings projections for the next fiscal year, IIVI is still trading below their intrinsic value, and their recent selloff presents a great opportunity to get in while the market price is still cheap compared to their valuation. While the business risks of trade disputes, and their ability to manage debt and the integration of Finisar are worth noting, these should ultimately not pose major threats to their ongoing operation and overall profitability, barring any drastic and unforeseen changes to policy and estimates of solvency related to the acquisition. Valuation suggests a market buy at the current price of $30.51, with a target of $39.00, suggesting 27.83% upside in share price appreciation.