

II-VI INC  
Form 10-Q  
November 08, 2011  
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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 September 30, 2011
- ☐ **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)

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|                                                                                                        |                                                              |
|--------------------------------------------------------------------------------------------------------|--------------------------------------------------------------|
| <b>PENNSYLVANIA</b><br>(State or other jurisdiction of<br>incorporation or organization)               | <b>25-1214948</b><br>(I.R.S. Employer<br>Identification No.) |
| <b>375 Saxonburg Boulevard</b><br><br><b>Saxonburg, PA</b><br>(Address of principal executive offices) | <b>16056</b><br>(Zip Code)                                   |
| <b>Registrant's telephone number, including area code: 724-352-4455</b>                                |                                                              |

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 ☒ 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, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act:

|                                                             |                                                    |
|-------------------------------------------------------------|----------------------------------------------------|
| Large accelerated filer <input checked="" type="checkbox"/> | Accelerated filer <input type="checkbox"/>         |
| Non-accelerated filer <input type="checkbox"/>              | Smaller reporting company <input type="checkbox"/> |

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 November 1, 2011, 62,714,661 shares of Common Stock, no par value, of the registrant were outstanding.

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II-VI Incorporated and Subsidiaries

## Condensed Consolidated Balance Sheets (Unaudited)

(\$000)

|                                                                                                                                               | September 30,<br>2011 | June 30,<br>2011  |
|-----------------------------------------------------------------------------------------------------------------------------------------------|-----------------------|-------------------|
| <b>Assets</b>                                                                                                                                 |                       |                   |
| <b>Current Assets</b>                                                                                                                         |                       |                   |
| Cash and cash equivalents                                                                                                                     | \$ 110,786            | \$ 149,460        |
| Short-term investment                                                                                                                         | 565                   |                   |
| Accounts receivable less allowance for doubtful accounts of \$1,354 at September 30, 2011 and \$766 at June 30, 2011                          | 91,919                | 90,606            |
| Inventories                                                                                                                                   | 140,399               | 126,430           |
| Deferred income taxes                                                                                                                         | 8,626                 | 8,215             |
| Prepaid and refundable income taxes                                                                                                           | 4,926                 | 8,606             |
| Prepaid and other current assets                                                                                                              | 8,574                 | 12,223            |
| <b>Total Current Assets</b>                                                                                                                   | <b>365,795</b>        | <b>395,540</b>    |
| Property, plant & equipment, net                                                                                                              | 147,263               | 138,135           |
| Goodwill                                                                                                                                      | 85,833                | 64,262            |
| Other intangible assets, net                                                                                                                  | 41,942                | 28,732            |
| Investments                                                                                                                                   | 15,777                | 15,458            |
| Deferred income taxes                                                                                                                         | 3,477                 | 3                 |
| Other assets                                                                                                                                  | 5,841                 | 5,072             |
| <b>Total Assets</b>                                                                                                                           | <b>\$ 665,928</b>     | <b>\$ 647,202</b> |
| <b>Liabilities and Shareholders' Equity</b>                                                                                                   |                       |                   |
| <b>Current Liabilities</b>                                                                                                                    |                       |                   |
| Accounts payable                                                                                                                              | \$ 24,156             | \$ 25,065         |
| Accrued compensation and benefits                                                                                                             | 23,130                | 33,889            |
| Accrued income tax payable                                                                                                                    | 3,836                 | 5,290             |
| Deferred income taxes                                                                                                                         | 98                    | 141               |
| Other accrued liabilities                                                                                                                     | 23,076                | 22,853            |
| Current portion of long-term debt                                                                                                             | 3,902                 | 3,729             |
| <b>Total Current Liabilities</b>                                                                                                              | <b>78,198</b>         | <b>90,967</b>     |
| Long-term debt                                                                                                                                | 22,000                | 15,000            |
| Deferred income taxes                                                                                                                         | 5,881                 | 6,641             |
| Other liabilities                                                                                                                             | 12,497                | 11,493            |
| <b>Total Liabilities</b>                                                                                                                      | <b>118,576</b>        | <b>124,101</b>    |
| <b>Shareholders' Equity</b>                                                                                                                   |                       |                   |
| Preferred stock, no par value; authorized 5,000,000 shares; none issued                                                                       |                       |                   |
| Common stock, no par value; authorized 100,000,000 shares; issued 69,200,592 shares at September 30, 2011; 69,077,492 shares at June 30, 2011 | 165,951               | 159,186           |

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|                                                                                                       |            |            |
|-------------------------------------------------------------------------------------------------------|------------|------------|
| Accumulated other comprehensive income                                                                | 14,056     | 13,116     |
| Retained earnings                                                                                     | 396,944    | 378,365    |
|                                                                                                       | 576,951    | 550,667    |
| Treasury stock, at cost, 6,492,211 shares at September 30, 2011 and 6,393,659 shares at June 30, 2011 | 30,259     | 28,293     |
| Total II-VI Incorporated Shareholders' Equity                                                         | 546,692    | 522,374    |
| Noncontrolling Interests                                                                              | 660        | 727        |
| Total Shareholders' Equity                                                                            | 547,352    | 523,101    |
| Total Liabilities and Shareholders' Equity                                                            | \$ 665,928 | \$ 647,202 |

- 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<br>September 30, |           |
|------------------------------------------------------------------------------|-------------------------------------|-----------|
|                                                                              | 2011                                | 2010      |
| Revenues, including contract research and development                        |                                     |           |
| Domestic                                                                     | \$ 55,569                           | \$ 49,238 |
| International                                                                | 82,804                              | 70,896    |
| Total Revenues                                                               | 138,373                             | 120,134   |
| Costs, Expenses and Other Expense (Income)                                   |                                     |           |
| Cost of goods sold, including contract research and development              | 83,363                              | 70,898    |
| Internal research and development                                            | 5,163                               | 3,846     |
| Selling, general and administrative                                          | 26,812                              | 22,729    |
| Interest expense                                                             | 59                                  | 30        |
| Other expense (income), net                                                  | (1,630)                             | (2,062)   |
| Total Costs, Expenses, and Other Expense (Income)                            | 113,767                             | 95,441    |
| Earnings Before Income Taxes                                                 | 24,606                              | 24,693    |
| Income Taxes                                                                 | 5,892                               | 6,292     |
| Net Earnings                                                                 | 18,714                              | 18,401    |
| Less: Net Earnings Attributable to Noncontrolling Interests                  | 135                                 | 34        |
| Net Earnings Attributable to II-VI Incorporated                              | \$ 18,579                           | \$ 18,367 |
| Net Earnings Attributable to II-VI Incorporated: Basic Earnings Per Share:   | \$ 0.30                             | \$ 0.30   |
| Net Earnings Attributable to II-VI Incorporated: Diluted Earnings Per Share: | \$ 0.29                             | \$ 0.29   |
| <i>- See notes to condensed consolidated financial statements.</i>           |                                     |           |

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II-VI Incorporated and Subsidiaries

Condensed Consolidated Statements of Cash Flows (Unaudited)

(\$000)

|                                                                                               | Three Months Ended<br>September 30, |            |
|-----------------------------------------------------------------------------------------------|-------------------------------------|------------|
|                                                                                               | 2011                                | 2010       |
| <b>Cash Flows from Operating Activities</b>                                                   |                                     |            |
| Net earnings                                                                                  | \$ 18,714                           | \$ 18,401  |
| Adjustments to reconcile net earnings to net cash provided by (used in) operating activities: |                                     |            |
| Depreciation                                                                                  | 7,287                               | 6,225      |
| Amortization                                                                                  | 1,023                               | 609        |
| Share-based compensation expense                                                              | 4,575                               | 3,732      |
| Loss (gain) on foreign currency remeasurements and transactions                               | 255                                 | (1,244)    |
| Earnings from equity investments                                                              | (326)                               | (170)      |
| Gain from sale of equity investment                                                           |                                     | (168)      |
| Deferred income taxes                                                                         | (871)                               | (1,387)    |
| Excess tax benefits from share-based compensation expense                                     | (45)                                | (450)      |
| Increase (decrease) in cash from changes in:                                                  |                                     |            |
| Accounts receivable                                                                           | 2,812                               | (1,175)    |
| Inventories                                                                                   | (11,976)                            | (9,928)    |
| Accounts payable                                                                              | (933)                               | 698        |
| Income taxes                                                                                  | 3,359                               | 3,116      |
| Other operating net assets                                                                    | (9,584)                             | (7,199)    |
| Net cash provided by operating activities                                                     | 14,290                              | 11,060     |
| <b>Cash Flows from Investing Activities</b>                                                   |                                     |            |
| Purchase of business, net of cash acquired                                                    | (46,141)                            |            |
| Additions to property, plant & equipment                                                      | (12,712)                            | (5,281)    |
| Investments in unconsolidated business                                                        |                                     | (1,180)    |
| Other investing activities                                                                    | 23                                  | 217        |
| Net cash used in investing activities                                                         | (58,830)                            | (6,244)    |
| <b>Cash Flows from Financing Activities</b>                                                   |                                     |            |
| Proceeds from long-term borrowings                                                            | 7,000                               |            |
| Payment on long-term borrowings                                                               | (1,295)                             |            |
| Proceeds from exercises of stock options                                                      | 179                                 | 859        |
| Excess tax benefits from share-based compensation expense                                     | 45                                  | 450        |
| Net cash provided by financing activities                                                     | 5,929                               | 1,309      |
| Effect of exchange rate changes on cash and cash equivalents                                  | (63)                                | (959)      |
| Net (decrease) increase in cash and cash equivalents                                          | (38,674)                            | 5,166      |
| Cash and Cash Equivalents at Beginning of Period                                              | 149,460                             | 108,026    |
| Cash and Cash Equivalents at End of Period                                                    | \$ 110,786                          | \$ 113,192 |

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|                            |          |          |
|----------------------------|----------|----------|
| Cash paid for interest     | \$ 72    | \$ 43    |
| Cash paid for income taxes | \$ 3,006 | \$ 4,249 |

- See notes to condensed consolidated financial statements.

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II-VI Incorporated and Subsidiaries

Condensed Consolidated Statement of Shareholders' Equity (Unaudited)

(000)

|                                                            |                    | Accumulated            |            |                         |                      |                          |             |                              |            |
|------------------------------------------------------------|--------------------|------------------------|------------|-------------------------|----------------------|--------------------------|-------------|------------------------------|------------|
|                                                            |                    | Other                  |            |                         |                      |                          |             |                              |            |
|                                                            |                    | Common Stock<br>Shares | Amount     | Comprehensive<br>Income | Retained<br>Earnings | Treasury Stock<br>Shares | Amount      | Non-Controlling<br>Interests | Total      |
| BALANCE                                                    | JUNE 30, 2011      | 69,077                 | \$ 159,186 | \$ 13,116               | \$ 378,365           | (6,394)                  | \$ (28,293) | \$ 727                       | \$ 523,101 |
| Shares issued under share-based<br>compensation plans      |                    | 124                    | 179        |                         |                      |                          |             |                              | 179        |
| Share-based compensation expense                           |                    |                        | 4,575      |                         |                      |                          |             |                              | 4,575      |
| Net earnings                                               |                    |                        |            |                         | 18,579               |                          |             | 135                          | 18,714     |
| Treasury stock under deferred<br>compensation arrangements |                    |                        | 1,966      |                         |                      | (98)                     | (1,966)     |                              |            |
| Excess tax benefits from<br>share-based compensation       |                    |                        | 45         |                         |                      |                          |             |                              | 45         |
| Distribution of noncontrolling<br>interests                |                    |                        |            |                         |                      |                          |             | (202)                        | (202)      |
| Foreign currency translation<br>adjustment                 |                    |                        |            | 940                     |                      |                          |             |                              | 940        |
| BALANCE                                                    | September 30, 2011 | 69,201                 | \$ 165,951 | \$ 14,056               | \$ 396,944           | (6,492)                  | \$ (30,259) | \$ 660                       | \$ 547,352 |

- See notes to condensed consolidated financial statements.

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**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 (sometimes referred to herein as "II-VI" or the "Company") for the three months ended September 30, 2011 and 2010 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 consolidated financial statements and notes thereto included in the Company's annual report on Form 10-K for the year ended June 30, 2011. The consolidated results of operations for the three months ended September 30, 2011 are not necessarily indicative of the results to be expected for the full fiscal year. The June 30, 2011 Condensed Consolidated Balance Sheet information was derived from the Company's audited financial statements. Effective July 1, 2011, the Company renamed its former Compound Semiconductor Group reporting segment the Advanced Products Group. This name change has been reflected in this Form 10-Q and had no financial impact on the Company's consolidated financial statements and footnote disclosures.

**Note 2. Recent Accounting Pronouncements**

In September 2011, the Financial Accounting Standards Board ("FASB") issued an accounting standard update related to goodwill impairment testing. The objective of the accounting standard update is to simplify how entities test goodwill for impairment by permitting an assessment of qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. This update also allows entities an unconditional option to bypass this qualitative assessment and proceed directly to performing the first step of the goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period. This accounting standard update is effective for annual and interim goodwill impairment tests performed for fiscal years beginning on or after December 15, 2011, with early adoption permitted. The Company is currently assessing the impact of this update but does not expect it to have a significant impact on the consolidated financial statements.

In June 2011, the FASB issued changes to the presentation of comprehensive income which requires entities to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, these changes require an entity to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statements where the components of net income and the components of other comprehensive income are presented. The option to present components of other comprehensive income as part of the statement of changes in stockholders' equity, which is the method of presentation used by the Company, will no longer be permitted. In addition, these changes will have no impact on the calculation and presentation of earnings per share. These changes, with retrospective application, become effective for the Company for interim and annual periods beginning in fiscal year 2013, with early adoption permitted. Other than the change in presentation, these changes will not have an impact on the consolidated financial statements.

In May 2011, the FASB issued an accounting standard update on fair value measurement and disclosure requirements. The update amends certain fair value measurement guidance and expands disclosure requirements primarily for fair value measurements utilizing significant unobservable inputs (Level 3) and items not measured at fair value but for which fair value must be disclosed. This update becomes effective for the Company for interim and annual reporting periods beginning in the third quarter of fiscal year 2012. The adoption of this standard is not expected to have a significant impact on the Company's consolidated financial statements.

In January 2010, the FASB issued amended standards requiring additional fair value disclosures. The amended standards require disclosures of transfers in and out of Levels 1 and 2 of the fair value hierarchy, as well as requiring gross basis disclosures for purchases, sales, issuances and settlements within the Level 3 reconciliation. Additionally, the update clarifies the requirement to determine the level of disaggregation for fair value measurement disclosures and to disclose valuation techniques and inputs used for both recurring and nonrecurring fair value measurements in either Level 2 or Level 3. The



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Company adopted the new guidance in the third quarter of fiscal 2010, except for the disclosures related to purchases, sales, issuance and settlements, which was adopted in the first quarter of fiscal 2012. Because these new standards are related primarily to disclosures, their adoption did not have a significant impact on the Company's consolidated financial statements.

**Note 3. Stock Split**

On May 17, 2011, the Company's Board of Directors declared a two-for-one stock split, in the form of a stock dividend, of the Company's common stock for shareholders of record on June 3, 2011. The stock split was distributed on June 24, 2011, issuing one additional share of common stock for every share of common stock held. The applicable share and per share data for all periods included herein have been restated to give effect to this stock split.

**Note 4. Acquisitions*****Aegis Lightwave, Inc.***

In July 2011, the Company acquired all of the outstanding shares of Aegis Lightwave, Inc. (Aegis), a privately-held company based in Woburn, Massachusetts with additional locations in New Jersey and Australia, for approximately \$46.1 million, net of cash acquired of \$8.4 million. Aegis supplies tunable optical devices required for high speed optical networks that provide the bandwidth expansion necessary for increasing Internet traffic. As a result of the acquisition, the Company will enhance its product portfolio for the increasing deployments of 40G and 100G in flexible and reconfigurable optical networks, including those aimed at delivering fiber to the home services over passive optical networks. Aegis will work cooperatively with Photop Technologies, Inc. (Photop) to achieve synergies by leveraging and expanding combined telecommunication product offerings around the world. Due to the timing of the acquisition, the Company is in the process of completing its fair market valuation, including the valuation of certain tangible and intangible assets. 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 Aegis during fiscal year 2012 (\$000):

|                               |               |
|-------------------------------|---------------|
| <b>Assets</b>                 |               |
| Short-term investment         | \$ 565        |
| Accounts receivable, net      | 4,572         |
| Inventories                   | 2,853         |
| Prepaid and other assets      | 238           |
| Deferred income taxes         | 9,976         |
| Property, plant & equipment   | 2,900         |
| Intangible assets             | 14,000        |
| Goodwill                      | 21,202        |
| <br>Total assets acquired     | <br>\$ 56,306 |
| <b>Liabilities</b>            |               |
| Accounts payable              | \$ 1,375      |
| Deferred income taxes         | 5,655         |
| Long-term debt                | 1,295         |
| Other accrued liabilities     | 1,840         |
| <br>Total liabilities assumed | <br>\$ 10,165 |
| <br>Net assets acquired       | <br>\$ 46,141 |

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The goodwill of Aegis of \$21.2 million is included in the Near-Infrared Optics segment and is attributed to the expected synergies and the assembled workforce of Aegis. None of the goodwill is deductible for income tax purposes. The fair value and gross contractual amount of accounts receivable acquired was \$4.6 million, as the Company expects the entire amount to be collectible as of the acquisition date. The \$10.0 million of deferred tax assets of Aegis are primarily related to net operating loss and tax credit carryforwards. The Company has considered any carryforward limitations and expirations and expects to fully utilize these carryforwards to offset future income taxes.

The amount of revenues and earnings of Aegis included in the Company's Condensed Consolidated Statement of Earnings for the three months ended September 30, 2011 was revenues of \$4.8 million and net loss of \$0.4 million, respectively. In conjunction with the acquisition of Aegis, the Company incurred approximately \$0.9 million of transaction costs, which were expensed in fiscal year 2011 in accordance with current accounting standards.

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The following unaudited pro-forma consolidated results of operations for fiscal year 2011 have been prepared as if the acquisition of Aegis had occurred on July 1, 2010, the beginning of the Company's fiscal year 2011, which is the fiscal year prior to acquisition (\$000 except per share data).

|                                                 | Three Months Ended<br>September 30,<br>2011 | Three Months Ended<br>September 30,<br>2010 |
|-------------------------------------------------|---------------------------------------------|---------------------------------------------|
| Net revenues                                    | \$ 138,373                                  | \$ 127,004                                  |
| Net earnings attributable to II-VI Incorporated | 18,579                                      | 18,998                                      |
| Basic earnings per share                        | 0.30                                        | 0.31                                        |
| Diluted earnings per share                      | 0.29                                        | 0.30                                        |

The pro-forma results are not necessarily indicative of what actually would have occurred if the transaction had taken place at the beginning of the period, are not intended to be a projection of future results and do not reflect any cost savings that might be achieved from the combined operations.

**Max Levy Autograph, Inc.**

In December 2010, the Company acquired all of the outstanding shares of Max Levy Autograph, Inc. (MLA), a privately-held company based in Philadelphia, Pennsylvania, for approximately \$12.8 million, net of cash acquired. MLA manufactures micro-fine conductive mesh patterns for optical, mechanical and ceramic components for applications such as circuitry, metrology standards, targeting calibration and suppression of electro-magnetic interference. As a result of the acquisition, the companies have combined efforts to enhance product offerings for their military-based customers. The following table presents the allocation of the purchase price of the assets acquired and liabilities assumed at the date of acquisition (\$000):

|                                  |               |
|----------------------------------|---------------|
| <b>Assets</b>                    |               |
| Accounts receivable, net         | \$ 586        |
| Inventories                      | 275           |
| Prepaid and other current assets | 91            |
| Deferred income taxes            | 171           |
| Property, plant and equipment    | 2,845         |
| Intangible assets                | 5,610         |
| Goodwill                         | 6,485         |
| <br>Total assets acquired        | <br>\$ 16,063 |
| <br><b>Liabilities</b>           |               |
| Accounts payable                 | \$ 154        |
| Deferred income taxes            | 2,625         |
| Other accrued liabilities        | 471           |
| <br>Total liabilities assumed    | <br>\$ 3,250  |
| <br>Net assets acquired          | <br>\$ 12,813 |

The goodwill of MLA of \$6.5 million is included in the Military & Materials segment. The goodwill recognized is attributed to the expected synergies and the assembled workforce of MLA. None of the goodwill is deductible for income tax purposes.

The operating results of MLA since the date of acquisition have been included in the Company's results of operations in the Company's Military & Materials segment and are insignificant. Pro-forma financial information has not been provided for the acquisition of MLA as it was

not material to the Company's overall financial results of operations.

**Table of Contents****Note 5. Investments*****Langfang Haobo Diamond Co., Ltd.***

In July 2009, the Company acquired a 40% non-controlling interest in Langfang Haobo Diamond Co. Ltd. ( Haobo ) to form a joint venture in Beijing, China. The total carrying value of the investment recorded as of September 30, 2011 and June 30, 2011 was \$5.2 million and \$5.3 million, respectively. This investment is accounted for under the equity method of accounting. During the three months ended September 30, 2011 and 2010, the Company's pro-rata share of losses from this investment was \$0.1 million and was recorded in other expense (income), net in the Condensed Consolidated Statements of Earnings.

***Fuxin Electronic Technology Company***

In March 2007, the Company acquired a 10% non-controlling minority interest in Guangdong Fuxin Electronic Technology ( Fuxin ) based in Guangdong Province, China for \$3.6 million. In July 2008, the Company completed an additional non-controlling investment of 10.2% of the equity interests of Fuxin for approximately \$4.9 million. The Company has a total equity investment in Fuxin of 20.2%, which is accounted for under the equity method of accounting. The total carrying value of the investment recorded at September 30, 2011 and June 30, 2011 was \$10.6 million and \$10.1 million, respectively. During the three months ended September 30, 2011 and 2010, the Company's pro-rata share of earnings from this investment was \$0.4 million and \$0.2 million, respectively, and was recorded in other expense (income), net in the Condensed Consolidated Statements of Earnings.

**Note 6. Inventories**

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

|                  | September 30,<br>2011 | June 30,<br>2011 |
|------------------|-----------------------|------------------|
| Raw materials    | \$ 53,790             | \$ 53,108        |
| Work in progress | 43,282                | 36,265           |
| Finished goods   | 43,327                | 37,057           |
|                  | \$ 140,399            | \$ 126,430       |

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### Note 7. Property, Plant and Equipment

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

|                               | September 30,<br>2011 | June 30,<br>2011 |
|-------------------------------|-----------------------|------------------|
| Land and land improvements    | \$ 2,043              | \$ 2,043         |
| Buildings and improvements    | 74,005                | 72,474           |
| Machinery and equipment       | 207,470               | 197,136          |
| Construction in progress      | 17,719                | 12,862           |
|                               | 301,237               | 284,515          |
| Less accumulated depreciation | (153,974)             | (146,380)        |
|                               | \$ 147,263            | \$ 138,135       |

### Note 8. Goodwill and Intangible Assets

Changes in the carrying amount of goodwill are as follows for the three months ended September 30, 2011 (\$000):

|                              | Three Months Ended September 30, 2011 |                         |                            |                               |           |
|------------------------------|---------------------------------------|-------------------------|----------------------------|-------------------------------|-----------|
|                              | Infrared<br>Optics                    | Near-Infrared<br>Optics | Military<br>&<br>Materials | Advanced<br>Products<br>Group | Total     |
| Balance beginning of period  | \$ 10,038                             | \$ 33,511               | \$ 10,399                  | \$ 10,314                     | \$ 64,262 |
| Goodwill acquired Aegis      |                                       | 21,202                  |                            |                               | 21,202    |
| Foreign currency translation | (204)                                 | 573                     |                            |                               | 369       |
| Balance end of period        | \$ 9,834                              | \$ 55,286               | \$ 10,399                  | \$ 10,314                     | \$ 85,833 |

In connection with the acquisition of Aegis in July 2011, the Company recorded the excess purchase price over the net assets of the business acquired as goodwill in the accompanying September 30, 2011 Condensed Consolidated Balance Sheet, which was based on the preliminary purchase price allocation. The Company intends to finalize its accounting for the acquisition of Aegis during fiscal year 2012.

The Company reviews the recoverability of goodwill at least annually and any time business conditions indicate a potential change in recoverability. The evaluation of impairment involves comparing the current fair value of the Company's reporting units to the recorded value (including goodwill). The Company uses a discounted cash flow model (DCF model) and a market analysis to determine the current fair value of its reporting units. A number of significant assumptions and estimates are involved in estimating the forecasted cash flows used in the DCF model, including markets and market shares, sales volume and pricing, costs to produce, working capital changes and income tax rates. Management considers historical experience and all available information at the time the fair values of the reporting units are estimated. However, actual fair values that could be realized could differ from those used to evaluate the impairment of goodwill.

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The gross carrying amount and accumulated amortization of the Company's intangible assets other than goodwill as of September 30, 2011 and June 30, 2011 were as follows (\$000):

|                | September 30, 2011    |                          |                  | June 30, 2011         |                          |                  |
|----------------|-----------------------|--------------------------|------------------|-----------------------|--------------------------|------------------|
|                | Gross Carrying Amount | Accumulated Amortization | Net Book Value   | Gross Carrying Amount | Accumulated Amortization | Net Book Value   |
| Patents        | \$ 23,104             | \$ (6,330)               | \$ 16,774        | \$ 16,009             | \$ (5,843)               | \$ 10,166        |
| Trademarks     | 11,135                | (832)                    | 10,303           | 11,074                | (811)                    | 10,263           |
| Customer Lists | 21,280                | (6,415)                  | 14,865           | 14,327                | (6,024)                  | 8,303            |
| Other          | 1,387                 | (1,387)                  |                  | 1,387                 | (1,387)                  |                  |
| <b>Total</b>   | <b>\$ 56,906</b>      | <b>\$ (14,964)</b>       | <b>\$ 41,942</b> | <b>\$ 42,797</b>      | <b>\$ (14,065)</b>       | <b>\$ 28,732</b> |

In connection with the acquisition of Aegis, the Company recorded identifiable intangible assets of \$14.0 million as a result of the preliminary valuation. The Company intends to finalize its identifiable intangible asset valuation for Aegis during fiscal year 2012.

Amortization expense recorded on these intangible assets was \$1.0 million and \$0.6 million, for the three months ended September 30, 2011 and 2010, respectively. The patents are being amortized over a range of 120 to 180 months with a weighted average remaining life of approximately 130 months. The customer lists are being amortized over approximately 120 months with a weighted average remaining life of approximately 103 months. The gross carrying amount of trademarks includes \$9.6 million of acquired trade names resulting from the acquisitions of Marlow Industries, Inc., Photop and MLA. These trade names have indefinite lives and 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 of the portion relating to the Company's German subsidiaries and Photop.

At September 30, 2011, the estimated amortization expense for existing intangible assets for each of the five succeeding fiscal years is as follows (\$000):

Year Ending June 30,

|                |          |
|----------------|----------|
| Remaining 2012 | \$ 3,074 |
| 2013           | 3,756    |
| 2014           | 3,354    |
| 2015           | 3,098    |
| 2016           | 3,030    |

## Note 9. Debt

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

|                                                                                           | September 30, 2011 | June 30, 2011 |
|-------------------------------------------------------------------------------------------|--------------------|---------------|
| Line of credit, interest at the LIBOR Rate, as defined, plus 0.625%                       | \$ 22,000          | \$ 15,000     |
| Yen denominated term note, interest at the Japanese Yen Base Rate, as defined, plus 1.49% | 3,902              | 3,729         |
| <b>Total debt</b>                                                                         | <b>25,902</b>      | <b>18,729</b> |
| Current portion of long-term debt                                                         | 3,902              | 3,729         |

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|                                      |           |           |
|--------------------------------------|-----------|-----------|
| Long-term debt, less current portion | \$ 22,000 | \$ 15,000 |
|--------------------------------------|-----------|-----------|

The Company's credit facility is a \$50.0 million unsecured line of credit which, under certain conditions, may be expanded to \$80.0 million. The credit facility has a five-year term through June 2016 and has an interest rate of LIBOR, as defined in the agreement, plus 0.625% to 1.50%. Additionally, the facility is subject to certain covenants, including those relating to minimum interest coverage and maximum leverage ratios. As of September 30, 2011, the Company was in compliance with all financial covenants. The Company had available \$27.1 million and \$34.1 million under its line of credit as of September 30, 2011 and June 30, 2011, respectively. The amounts available under the Company's line of credit are reduced by outstanding letters of credit. As of September 30, 2011 and June 30, 2011, total outstanding letters of credit supported by the credit facilities were \$0.9 million.

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At September 30, 2011 and June 30, 2011, the Company had 300 million Yen borrowed under its Yen loan. 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 0.33% and 0.35% at September 30, 2011 and June 30, 2011, respectively.

The weighted average interest rate of total borrowings was 1.01% for the three months ending September 30, 2011. The weighted average of total borrowings was \$22.3 million for the three months ending September 30, 2011.

### **Note 10. Income Taxes**

The Company's year-to-date effective income tax rate at September 30, 2011 is 23.9% compared to an effective tax rate of 25.5% for the same period last fiscal year. The variation between the Company's effective tax rate and the U.S. statutory rate of 35.0% is primarily due to the consolidation of the Company's foreign operations, which are subject to income taxes at lower statutory rates. A change in the mix of pretax income from these various tax jurisdictions could have a material impact on our periodic effective tax rate.

U.S. GAAP clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes 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 September 30, 2011 and June 30, 2011, the gross unrecognized income tax benefit was \$5.4 million and \$5.0 million, respectively. The Company has classified the uncertain tax positions as non-current income tax liabilities, as the amounts are not expected to be paid within one year. If recognized, approximately \$4.3 million of the gross unrecognized tax benefits at September 30, 2011 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. Included in the \$5.4 million and \$5.0 million of gross unrecognized income tax benefit at September 30, 2011 and June 30, 2011, was \$0.3 million and \$0.2 million, respectively, of accrued interest and penalties. The Company expects a decrease of approximately \$0.8 million of unrecognized tax benefits within the next twelve months.

Fiscal years 2008 to 2011 remain open to examination by the United States Internal Revenue Service, fiscal years 2007 to 2011 remain open to examination by certain state jurisdictions, and fiscal years 2005 to 2011 remain open to examination by certain foreign taxing jurisdictions. As of September 30, 2011, the Company's fiscal year 2009 federal income tax return is under examination by the United States Internal Revenue Service and the Company's fiscal years 2007, 2008, and 2009 California state income tax returns are under examination by the State of California's Franchise Tax Board.

**Table of Contents****Note 11. Earnings Per Share**

The following table sets forth the computation of earnings per share attributable to II-VI Incorporated for the periods indicated. Weighted average shares issuable upon the exercises of stock options that were not included in the calculation were approximately 124,000 and 524,000 for the three months ended September 30, 2011 and 2010, respectively, because they were anti-dilutive (000 except per share data):

|                                                                      | Three Months Ended<br>September 30, |           |
|----------------------------------------------------------------------|-------------------------------------|-----------|
|                                                                      | 2011                                | 2010      |
| Net earnings attributable to II-VI Incorporated                      | \$ 18,579                           | \$ 18,367 |
| Divided by:                                                          |                                     |           |
| Weighted average shares                                              | 62,698                              | 61,808    |
|                                                                      |                                     |           |
| Basic earnings attributable to II-VI Incorporated per common share   | \$ 0.30                             | \$ 0.30   |
|                                                                      |                                     |           |
| Net earnings attributable to II-VI Incorporated                      | \$ 18,579                           | \$ 18,367 |
| Divided by:                                                          |                                     |           |
| Weighted average shares                                              | 62,698                              | 61,808    |
| Dilutive effect of common stock equivalents                          | 1,367                               | 1,480     |
|                                                                      |                                     |           |
| Diluted weighted average common shares                               | 64,065                              | 63,288    |
|                                                                      |                                     |           |
| Diluted earnings attributable to II-VI Incorporated per common share | \$ 0.29                             | \$ 0.29   |

**Note 12. Segment Reporting**

The Company reports its business segments using the management approach model for segment reporting. 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 has four reportable segments. The Company's chief operating decision maker receives and reviews financial information in this format. The Company evaluates business segment performance based upon reported business segment earnings, which is defined as earnings before income taxes, interest and other income or expense. 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 at September 30, 2011: (i) Infrared Optics, which is the Company's infrared optics and material products businesses, HIGHYAG Lasertechnologie GmbH ( HIGHYAG ) and remaining corporate activities, primarily corporate assets and capital expenditures; (ii) Near-Infrared Optics, which is the Company's VLOC Incorporated subsidiary, and Vietnam near-infrared operations, Photop and Aegis; (iii) Military & Materials, which is the Company's Exotic Electro-Optics, Inc. ( EEO ) subsidiary, Pacific Rare Specialty Metals & Chemicals, Inc. subsidiary ( PRM ), and the Max Levy Autograph, Inc. subsidiary ( MLA ); and (iv) Advanced Products Group (formerly the Compound Semiconductor Group), which is comprised of the Company's Marlow Industries, Inc. ( Marlow ) subsidiary, the Wide Bandgap Materials Group ( WBG ) and the Worldwide Materials Group ( WMG ); WMG is responsible for the corporate research and development activities.

The Infrared Optics segment is divided into geographic locations in the U.S., Singapore, China, Germany, Switzerland, Japan, Belgium, the U.K. and Italy. The Infrared Optics segment is directed by a general manager, while each geographic location is also 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 brand name and used primarily in high-power CO<sub>2</sub> lasers. The Infrared Optics segment also manufactures fiber-delivered beam delivery systems and processing tools for industrial lasers sold under the HIGHYAG brand name.

The Near-Infrared Optics segment is located in the U.S., China, Vietnam, Australia, Germany, Japan, the U.K., Italy and Hong Kong. The Near-Infrared Optics segment is directed by a Corporate Executive Vice President and is further divided into production and administrative units that are directed by managers. The Near-Infrared Optics segment manufactures crystal materials, optics, microchip lasers and optoelectronic modules for use in optical communication networks and other diverse consumer and commercial applications sold under the Photop brand name.

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and manufactures tunable optical devices required for high speed optical networks sold under the Aegis and AOFR brand names. The Near-Infrared Optics segment also 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 ( YAG ) lasers, yttrium lithium fluoride ( YLF ) lasers and ultra-violet ( UV ) Filter components sold under the VLOC brand name.

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The Military & Materials segment is located in the U.S. and the Philippines. The Military & Materials segment is directed by a Corporate Vice President, while each geographic location is directed by a general manager. The Military & Materials segment is further divided into production and administrative units that are directed by managers. The Military & Materials segment designs, manufactures and markets infrared products for military applications under the EEO brand name, refines specialty metals, primarily selenium and tellurium under the PRM brand name, and manufactures and markets micro-fine conductive mesh patterns for optical, mechanical, and ceramic components for applications under the MLA brand name.

The Advanced Products Group is located in the U.S., Japan, China, Vietnam and Germany and is directed by a Corporate Executive Vice President. In the Advanced Products Group segment, Marlow designs and manufactures thermoelectric cooling and power generation solutions for use in defense and space, telecommunications, medical, consumer and industrial markets. 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 WMG Group directs the corporate research and development initiatives.

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

In July 2011, the Company completed its acquisition of Aegis. See Note 4. Acquisitions. Aegis is combined with the Company's Near-Infrared segment for financial reporting purposes. Segment earnings for the Near-Infrared segment include the operating results of Aegis for the period ended September 30, 2011.

In December 2010, the Company completed its acquisition of MLA. See Note 4. Acquisitions. MLA is combined with the Company's Military & Materials segment for financial reporting purposes. Segment earnings for the Military & Materials segment include the operating results of MLA for the period ended September 30, 2011.

The following table summarizes selected financial information of the Company's operations for the periods indicated by segment (\$000):

|                                                | 0000000                               | 0000000                 | 0000000                    | 0000000                       | 0000000      | 0000000    |
|------------------------------------------------|---------------------------------------|-------------------------|----------------------------|-------------------------------|--------------|------------|
|                                                | Three Months Ended September 30, 2011 |                         |                            |                               |              |            |
|                                                | Infrared<br>Optics                    | Near-Infrared<br>Optics | Military<br>&<br>Materials | Advanced<br>Products<br>Group | Eliminations | Total      |
| Revenues                                       | \$ 50,796                             | \$ 38,110               | \$ 23,659                  | \$ 25,808                     | \$           | \$ 138,373 |
| Inter-segment revenues                         | 658                                   | 222                     | 1,752                      | 784                           | (3,416)      |            |
| Segment earnings                               | 12,357                                | 1,708                   | 2,962                      | 6,008                         |              | 23,035     |
| Interest expense                               |                                       |                         |                            |                               |              | (59)       |
| Other income, net                              |                                       |                         |                            |                               |              | 1,630      |
| Income taxes                                   |                                       |                         |                            |                               |              | (5,892)    |
| Net earnings                                   |                                       |                         |                            |                               |              | 18,714     |
| Depreciation and amortization                  | 2,195                                 | 4,215                   | 963                        | 937                           |              | 8,310      |
| Segment assets                                 | 201,558                               | 270,608                 | 92,295                     | 101,467                       |              | 665,928    |
| Expenditures for property, plant and equipment | 1,700                                 | 5,740                   | 1,988                      | 3,284                         |              | 12,712     |
| Equity investments                             |                                       |                         |                            | 15,777                        |              | 15,777     |
| Goodwill                                       | 9,834                                 | 55,286                  | 10,399                     | 10,314                        |              | 85,833     |

|                        | 0000000                               | 0000000                 | 0000000                    | 0000000                       | 0000000      | 0000000    |
|------------------------|---------------------------------------|-------------------------|----------------------------|-------------------------------|--------------|------------|
|                        | Three Months Ended September 30, 2010 |                         |                            |                               |              |            |
|                        | Infrared<br>Optics                    | Near-Infrared<br>Optics | Military<br>&<br>Materials | Advanced<br>Products<br>Group | Eliminations | Total      |
| Revenues               | \$ 41,226                             | \$ 36,945               | \$ 20,135                  | \$ 21,828                     | \$           | \$ 120,134 |
| Inter-segment revenues | 513                                   | 51                      | 1,340                      | 1,066                         | (2,970)      |            |
| Segment earnings       | 8,648                                 | 6,881                   | 3,721                      | 3,411                         |              | 22,661     |

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|                                                |         |         |        |        |         |
|------------------------------------------------|---------|---------|--------|--------|---------|
| Interest expense                               |         |         |        |        | (30)    |
| Other income, net                              |         |         |        |        | 2,062   |
| Income taxes                                   |         |         |        |        | (6,292) |
| Net earnings                                   |         |         |        |        | 18,401  |
| Depreciation and amortization                  | 2,031   | 3,412   | 578    | 813    | 6,834   |
| Segment assets                                 | 215,434 | 181,641 | 54,515 | 85,497 | 537,087 |
| Expenditures for property, plant and equipment | 786     | 1,428   | 1,429  | 1,638  | 5,281   |
| Equity investments                             |         |         |        | 15,431 | 15,431  |
| Goodwill                                       | 9,869   | 32,353  | 3,914  | 10,314 | 56,450  |

**Table of Contents****Note 13. Share-Based Compensation**

The Compensation Committee of the Board of Directors of the Company grants employee stock option awards, restricted share awards and performance share awards under the Company's 2009 Omnibus Incentive Plan (the "Plan"). The Company records share-based compensation expense for these awards in accordance with U.S. GAAP which 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. During the three months ended September 30, 2011 and 2010, the Company recorded \$4.6 million and \$3.7 million, respectively, of share-based compensation expense in its Condensed Consolidated Statements of Earnings. The share-based compensation expense is allocated approximately 20% to cost of goods sold and 80% to selling, general and administrative expense in the Condensed Consolidated Statements of Earnings based on the employee classification of the grantees.

**Stock Options:**

The Company utilizes the Black-Scholes valuation model for estimating the fair value of stock option awards. During the three months ended September 30, 2011 and 2010, the weighted-average fair values of options granted under the Plan were \$9.33 and \$8.28 per option, respectively, using the following assumptions:

|                          | Three Months Ended<br>September 30, 2011 | Three Months Ended<br>September 30, 2010 |
|--------------------------|------------------------------------------|------------------------------------------|
| Risk free interest rate  | 1.07%                                    | 2.07%                                    |
| Expected volatility      | 59%                                      | 47%                                      |
| Expected life of options | 5.51 years                               | 6.60 years                               |
| Dividend yield           | 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 exercises and forfeitures of options by our employees. The dividend yield of zero is based on the fact that the Company has 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 generally estimated at a rate of 16%. 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 rate is higher than estimated. Generally, twenty percent of each stock option award may be exercised one year from the date of grant with comparable annual increases on a cumulative basis each year thereafter. The stock option plan also has vesting provisions predicated upon the death, retirement or disability of the grantee. Included in the \$4.6 million and \$3.7 million of share-based compensation expense for the three months ended September 30, 2011 and 2010, was \$2.9 million and \$2.6 million, respectively, related to the stock option expense.

**Restricted Share Awards:**

The restricted share awards compensation expense was calculated based on the number of shares expected to be earned by the grantee multiplied by the stock price at the date of grant and is being recognized over the vesting period. Generally, the

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restricted share awards have a three year cliff-vesting provision and an estimated forfeiture rate of 7.5%. Included in the \$4.6 million and \$3.7 million of share-based compensation expense for the three months ended September 30, 2011 and 2010, was \$0.8 million and \$0.4 million, respectively, related to restricted share awards.

### ***Performance Share Awards:***

The Compensation Committee granted certain named executive officers and employees performance share awards under the Plan. During the three months ended year ended September 30, 2011, the Company had three outstanding performance share grants covering the periods from July 2010 to June 2012, July 2011 to June 2013, and July 2011 to December 2014. The awards are intended to provide continuing emphasis on specified financial performance goals that the Company considers important contributors to long-term shareholder value. The awards are payable only if the Company achieves specified levels of revenue and/or cash flows from operations for the applicable performance periods.

In conjunction with the Company's acquisition of Photop, the Compensation Committee established a long-term performance and retention program under the Plan for certain Photop employees. This program covers periods from January 1, 2010 to December 31, 2012. Participants are eligible to receive performance shares following each of the calendar years 2010, 2011 and 2012. The awards are only payable if Photop achieves the levels of revenue and earnings specified for each calendar year performance period as well as certain other non-financial performance targets pre-established for such performance period.

Performance shares compensation expense is calculated based on the estimated number of shares expected to be earned multiplied by the stock price at the date of grant. Included in the \$4.6 million and \$3.7 million of share based compensation expense for the three months ended September 30, 2011 and 2010, was \$0.9 million and \$0.7 million, respectively, related to performance share awards.

### **Note 14. Fair Value of Financial Instruments**

The FASB defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous markets for the asset and liability in an orderly transaction between market participants at the measurement date. The Company estimates fair value of its financial instruments utilizing an established three-level hierarchy in accordance with U.S. GAAP. The hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date as follows:

Level 1 Valuation is based upon unadjusted quoted prices for identical assets or liabilities in active markets.

Level 2 Valuation is based upon quoted prices for similar assets and liabilities in active markets, or other inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instruments.

Level 3 Valuation is based upon other unobservable inputs that are significant to the fair value measurements.

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The classification of fair value measurements within the hierarchy is based upon the lowest level of input that is significant to the measurement. At September 30, 2011, the Company had foreign currency forward contracts recorded at fair value. The fair values of these instruments were measured using valuations based upon quoted prices for similar assets and liabilities in active markets (Level 2) and are valued by reference to similar financial instruments, adjusted for credit risk and restrictions and other terms specific to the contracts. At September 30, 2011, the Company had a contingent earnout arrangement recorded at fair value related to the acquisition of Photop. The fair value of the earnout arrangement was based on significant inputs not observable in the market and represents a Level 3 measurement as defined in ASC 820. The Company uses the income approach in measuring the fair value of the earnout arrangement, which included a 0.93% discount rate and an assumed 100% probability of achieving the financial targets under the earnout arrangement. The fair value remeasurement of the earnout arrangement for the three months ended September 30, 2011 was insignificant. In conjunction with the July 2011 acquisition of Aegis, the Company acquired a Level 1 investment in the form of a certificate of deposit that matures in July of 2012 and was recorded at fair value as of September 30, 2011. The following table provides a summary by level of the fair value of financial instruments that are measured on a recurring basis as of September 30, 2011:

| Fair Value Measurements at September 30, 2011 Using: |                    |                                                                                  |                                                           |                                                    |
|------------------------------------------------------|--------------------|----------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
|                                                      | September 30, 2011 | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| <b>Assets:</b>                                       |                    |                                                                                  |                                                           |                                                    |
| Certificate of deposit                               | \$ 565             | \$ 565                                                                           | \$                                                        | \$                                                 |
| <b>Liabilities:</b>                                  |                    |                                                                                  |                                                           |                                                    |
| Contingent earnout arrangement                       | \$ 5,985           | \$                                                                               | \$                                                        | \$ 5,985                                           |
| Foreign currency forward contracts                   | \$ 141             | \$                                                                               | \$ 141                                                    | \$                                                 |

| Fair Value Measurements at June 30, 2011 Using: |               |                                                                                  |                                                           |                                                    |
|-------------------------------------------------|---------------|----------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
|                                                 | June 30, 2011 | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| <b>Liabilities:</b>                             |               |                                                                                  |                                                           |                                                    |
| Contingent earnout arrangements                 | \$ 5,941      | \$                                                                               | \$                                                        | \$ 5,941                                           |
| Foreign currency forward contracts              | \$ 174        | \$                                                                               | \$ 174                                                    | \$                                                 |

**Note 15. Derivative Instruments**

The Company, from time to time, purchases foreign currency forward exchange contracts, primarily in Japanese Yen, that permit it to sell specified amounts of these foreign currencies expected to be received from its export sales for pre-established U.S. dollar amounts at specified dates. These contracts are entered into to limit transactional exposure to changes in currency exchange rates of export sales transactions in which settlement will occur in future periods and which otherwise would expose the Company, on the basis of its aggregate net cash flows in respective currencies, to foreign currency risk.

The Company has recorded the difference in the fair market value and the contract value of these contracts on the statement of financial position. These contracts had a total contract value of \$7.9 million and \$7.8 million at September 30, 2011 and June 30, 2011, respectively. As of September 30, 2011, these forward contracts had expiration dates ranging from October 4, 2011 through January 6, 2012 with Japanese Yen denominations individually ranging from 150 million Yen to 170 million Yen. The Company does not account for these contracts as hedges as defined by U.S. GAAP and records the change in the fair value of these contracts in the results of operations as they occur. The fair value measurement takes into consideration foreign currency rates and the current creditworthiness of the counterparties to these contracts, as applicable, and is based upon quoted prices for similar assets and liabilities in active markets, or other inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instruments and thus represents a Level 2 measurement. These

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contracts are recorded in Other accrued liabilities in the Company's Condensed Consolidated Balance Sheets. The change in the fair value of these contracts for the three months ended September 30, 2011 was insignificant.

**Table of Contents****Note 16. Commitments and Contingencies**

The Company records a warranty reserve as a charge against earnings based on a percentage of sales utilizing actual returns over the last twelve months. The following table summarizes the change in the carrying value of the Company's warranty reserve, which is a component of Other accrued liabilities in the Company's Condensed Consolidated Balance Sheet as of and for the three months ended September 30, 2011 (\$000):

|                                                          | Three Months Ended<br>September 30,<br>2011 |
|----------------------------------------------------------|---------------------------------------------|
| Balance Beginning of Period                              | \$ 1,187                                    |
| Payments made during the period                          | (277)                                       |
| Additional warranty liability recorded during the period | 371                                         |
| Balance End of Period                                    | \$ 1,281                                    |

**Note 17. Subsequent Event**

On October 24, 2011, Fabrinet, a company that is used as a contract manufacturer of certain products of the Company and the Company's customers, announced that flood waters had infiltrated the manufacturing facilities at its Chokchai campus in Pathum Thani, Thailand. Fabrinet also announced that it has not yet been able to make a full assessment of the damage but believes that production will not recommence at Chokchai during the quarter ending December 31, 2011, and likely significantly longer, and Fabrinet acknowledged that it may never again manufacture at the Chokchai location. As of the filing date of this Form 10-Q, the Company is not able to estimate the magnitude of the financial consequences to the Company related to the events affecting Fabrinet and is currently evaluating the situation to determine whether it will have a material adverse financial impact on the Company's financial results.

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### **Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

#### ***Forward-Looking Statements***

This Management's Discussion and Analysis contains forward-looking statements as defined by Section 21E of the Securities Exchange Act of 1934, as amended, including any statements regarding projected growth rates, markets, product development, financial position, capital expenditures and foreign currency exposure. Forward-looking statements are also identified by words such as expects, anticipates, intends, plans, projects or similar expressions.

Actual results could materially differ from such statements due to the following factors: materially adverse changes in economic or industry conditions generally (including capital markets) or in the markets served by the Company, the development and use of new technology and the actions of competitors. There are additional risk factors that could affect the Company's business, results of operations or financial condition. Investors are encouraged to review the risk factors set forth in the Company's most recent Form 10-K as filed with the Securities and Exchange Commission on August 26, 2011 and in this Form 10-Q.

#### ***Introduction***

II-VI Incorporated (II-VI, the Company, we, us or our), the worldwide leader in crystal growth technology, is a vertically-integrated manufacturing company that creates and markets products for diversified markets including industrial manufacturing, military and aerospace, high-power electronics and telecommunications and thermoelectronics applications.

The Company generates revenues, earnings and cash flows from developing, manufacturing and marketing high technology materials and derivative products for precision use in industrial, telecommunications, military, medical and aerospace applications. We also generate revenue, earnings and cash flows from external customer and government funded research and development contracts relating to the development and manufacture of new technologies, materials and products.

Our customer base includes original equipment manufacturers (OEM), laser end users, system integrators of high-power lasers, manufacturers of equipment and devices for industrial, telecommunications, security and monitoring applications, U.S. government prime contractors, various U.S. government agencies and thermoelectric solutions suppliers.

Effective July 1, 2011, the Company renamed its former Compound Semiconductor Group reporting segment the Advanced Products Group.

#### ***Critical Accounting Estimates***

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America and the Company's discussion and analysis of its financial condition and results of operations require the Company's management to make judgments, assumptions and estimates that affect the amounts reported in its condensed consolidated financial statements and accompanying notes. Note 1 of the Notes to Consolidated Financial Statements in the Company's most recent Form 10-K describes the significant accounting policies and methods used in the preparation of the Company's consolidated financial statements. Management bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates.

Management believes the Company's critical accounting estimates are those related to revenue recognition, allowance for doubtful accounts, warranty reserves, inventory valuation, valuation of long-lived assets including acquired intangibles and goodwill, accrual of bonus and profit sharing estimates, accrual of income tax liability estimates and accounting for share-based payments. Management believes these estimates to be critical because they are both important to the portrayal of the Company's financial condition and results of operations, and they require management to make judgments and estimates about matters that are inherently uncertain.

The Company recognizes revenues when the criteria of SEC Staff Accounting Bulletin: No. 104—Revenue Recognition in Financial Statements (SAB 104) are met. Revenues for product shipments are realizable when we have persuasive evidence of a sales arrangement, the product has been shipped or delivered, the sales price is fixed or determinable and collectability is reasonably assured. Title and risk of loss passes from the Company to its customer at the time of shipment in all cases with the exception of certain customers. For these customers, which represent approximately 5% of our consolidated revenues, title does not pass and revenue is not recognized until the customer has received the product at its physical location. The Company's



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revenue recognition policy is consistently applied across the Company's segments, product lines and geographical locations. Further, we do not have post-shipment obligations such as training or installation, customer acceptance provisions, credits and discounts, rebates and price protection or other similar privileges. Our distributors and agents are not granted price protection. Our distributors and agents, who comprise less than 10% of consolidated revenue, have no additional product return rights beyond the right to return defective products that are covered by our warranty policy. We believe our revenue recognition practices are consistent with SAB 104, and that we have adequately considered the requirements of ASC 605 Revenue Recognition. Revenues generated from transactions other than product shipments have historically accounted for less than 5% of the Company's consolidated revenues.

We establish an allowance for doubtful accounts and warranty reserves based on historical experience and believe the collection of revenues, net of these reserves, is reasonably assured. Our allowance for doubtful accounts and warranty reserve balances at September 30, 2011 was \$1.4 million and \$1.3 million, respectively. Our reserve estimates have historically been proven to be materially correct based upon actual charges incurred.

**New Accounting Standards**

See Note 2. Recent Accounting Pronouncements, to our unaudited financial statements in Part I, Item 1 of this Quarterly Report for a description of recent accounting pronouncements, including the expected dates of adoption and estimated effects, if any, on our consolidated financial statements.

**Results of Operations (\$000's, except per-share data)**

The following table sets forth bookings and select items from our Condensed Consolidated Statements of Earnings for the three months ended September 30, 2011 and 2010, respectively:

|                                                                            | Three Months Ended<br>September 30, 2011 |                          | Three Months Ended<br>September 30, 2010 |                          |
|----------------------------------------------------------------------------|------------------------------------------|--------------------------|------------------------------------------|--------------------------|
| Bookings                                                                   | \$ 130,247                               |                          | \$ 112,050                               |                          |
|                                                                            |                                          | <b>% of<br/>Revenues</b> |                                          | <b>% of<br/>Revenues</b> |
| Total Revenues                                                             | \$ 138,373                               | 100.0%                   | \$ 120,134                               | 100.0%                   |
| Cost of goods sold                                                         | 83,363                                   | 60.2                     | 70,898                                   | 59.0                     |
| Gross margin                                                               | 55,010                                   | 39.8                     | 49,236                                   | 41.0                     |
| Costs, expenses and other expense (income)                                 |                                          |                          |                                          |                          |
| Internal research and development                                          | 5,163                                    | 3.7                      | 3,846                                    | 3.2                      |
| Selling, general and administrative                                        | 26,812                                   | 19.4                     | 22,729                                   | 18.9                     |
| Interest expense and other expense (income), net                           | (1,571)                                  | (1.1)                    | (2,032)                                  | (1.7)                    |
| Earnings before income tax                                                 | 24,606                                   | 17.8                     | 24,693                                   | 20.6                     |
| Income taxes                                                               | 5,892                                    | 4.3                      | 6,292                                    | 5.2                      |
| Net earnings                                                               | 18,714                                   | 13.5                     | 18,401                                   | 15.3                     |
| Net earnings attributable to noncontrolling interest                       | 135                                      | 0.1                      | 34                                       | 0.0                      |
| Net earnings attributable to II-VI Incorporated                            | \$ 18,579                                | 13.4                     | \$ 18,367                                | 15.3                     |
| Net earnings attributable to II-VI Incorporated Diluted Earnings Per Share | \$ 0.29                                  |                          | \$ 0.29                                  |                          |

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The above results include MLA and Aegis for the three months ended September 30, 2011 only, as these acquisitions were completed in December 2010 and July 2011, respectively.

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### **Executive Summary**

Net earnings attributable to II-VI Incorporated for three months ending September 30, 2011 were \$18,579,000 (\$0.29 per-share diluted). This compares to net earnings attributable to II-VI Incorporated of \$18,367,000 (\$0.29 per-share diluted) for the same period last fiscal year. Despite the 15% increase in total revenues, net earnings were consistent when compared to the prior period primarily due to product mix at the Company's Photop business unit as well as higher commodity pricing at the Company's PRM business unit. Additionally, the Company continued to invest in internal research and development at Photop and Aegis in an effort to expand and improve current product offerings in the telecommunication market space. The Company benefited from an after-tax gain of approximately \$0.9 million during the three months ended September 30, 2011 related to the sale of a precious metal that partially offset the unfavorable impact of changes in foreign currency rates.

The Company is closely monitoring the changing economic conditions worldwide. Near the end of the three months ended September 30, 2011, the Company began to experience softening in its order patterns specific to the infrared optics market. In addition, the recent flooding events in Thailand have created uncertainty in our telecommunication businesses within the Near-Infrared Optics segment. Based on the information available, the Company is currently assessing whether these events will have a material adverse impact on its future results of operations.

### ***Consolidated***

**Bookings.** Bookings for the three months ended September 30, 2011 increased 16.2% to \$130,247,000, compared to \$112,050,000 for the same period last fiscal year. Bookings are defined as customer orders received that are expected to be converted to revenues over the next twelve months. For long-term customer orders, the Company does not include in bookings the portion of the customer order that is beyond twelve months, due to the inherent uncertainty of an order that far out in the future. In addition to the bookings from MLA and Aegis that were not owned in the same period last fiscal year, the increase for the three months ended September 30, 2011 compared to the same period last fiscal year was the result of demand within the Infrared Optics segment as high-power and low-power OEMs ordered at higher rates. The Marlow business unit also showed a strong bookings increase due to the seasonal ramp up of its gesture recognition product line, while increasing demand in China for selenium and tellurium had a favorable impact on bookings at the Company's PRM business unit. These positive bookings changes were somewhat offset by lower orders at the WBG business unit.

**Revenues.** Revenues for the three months ended September 30, 2011 increased 15.2% to \$138,373,000, compared to \$120,134,000 for the same period last fiscal year. In addition to the revenues from MLA and Aegis that were not owned in the same period last fiscal year, the increase for the three months ended September 30, 2011 compared to the same period last fiscal year was the result of increased demand from the Company's Infrared Optics, Military & Materials and Advanced Products Group segments. The Infrared Optics segment benefited from higher laser utilization rates and demand for the segment's replacement optics. The Military & Materials segment increased revenues as a result of demand from China for materials at the Company's PRM business unit. Within the Advanced Products Group segment, the WBG business unit increased shipment volume of silicon carbide products due to accelerated demand within defense and commercial application markets, while the Marlow business unit also recognized higher volume related to its gesture recognition product line. These increases in revenues were somewhat offset by lower shipment volume at the VLOC business unit within the Near-Infrared Optics segment as a result of decreased military demand for both the UV Filter product line and contract research and development activities.

**Gross margin.** Gross margin, which is defined as total revenues less cost of goods sold, for the three months ended September 30, 2011 was \$55,010,000, or 39.8% of total revenues, compared to \$49,236,000, or 41.0% of total revenues, for the same period last fiscal year. The slight decline in gross margin percentage was primarily the result of product mix shift to lower margin products at the Company's Photop business unit. In addition, higher raw material pricing of selenium and tellurium negatively impacted gross margin at the PRM business unit. These items were somewhat offset by improving gross margin at the Company's Marlow business unit due to production efficiencies realized for its gesture recognition product line.

**Internal research and development.** Company-funded internal research and development expenses for the three months ended September 30, 2011 were \$5,163,000, or 3.7% of revenues, compared to \$3,846,000, or 3.2% of revenues, for the same period last fiscal year. This increase in Company-funded internal research and development expenses was primarily the result of continued internal research and development investment at Photop focusing on the development of optical switching router modules for data network customers as well as certain coherent solutions for 40G and 100G optical networks. In addition, the Company incurred incremental internal research and development expenses with the addition of recently acquired Aegis, who is investing in new product development of optical channel monitors and high-power fiber couplers and combiners.

**Selling, general and administrative.** Selling, general and administrative expenses for the three months ended September 30, 2011 were \$26,812,000, or 19.4% of revenues, compared to \$22,729,000, or 18.9% of revenues, for the same period last fiscal year. Selling, general and administrative expense as a percentage of revenues has normalized with the slow recovery of the global economic recession and has remained consistent during the three months ended September 30, 2011 compared to the same period last fiscal year.



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**Interest expense and other expense (income), net.** Interest expense and other expense (income), net for the three months ended September 30, 2011 was income of \$1,571,000, compared to income of \$2,032,000 for the same period last fiscal year. The majority of interest expense and other expense (income), net for the three months ended September 30, 2011 was the result of a \$1.4 million gain related to the sale of precious metals inventory used in the production process. The majority of interest and other, net for the three months ended September 30, 2010 was the result of foreign currency gains of approximately \$1.2 million. In contrast, the Company recorded foreign currency losses of approximately \$0.3 million during the three months ended September 30, 2011. The change in foreign currency gain (loss) was the result of fluctuations in the Company's foreign currency exchange rates.

**Income taxes.** The Company's year-to-date effective income tax rate at September 30, 2011 was 23.9% compared to an effective tax rate of 25.5% for the same period last fiscal year. The decrease in the effective tax rate was primarily due to the projected mix of pre-tax income shifting to lower tax jurisdictions such as Vietnam, China and the Philippines. The variation between the Company's effective tax rate and the U.S. statutory rate of 35% is primarily due to the Company's foreign operations which are subject to income taxes at lower statutory rates.

**Segment Reporting**

Bookings, revenues and segment earnings for the Company's reportable segments are discussed below. Segment earnings differ from income from operations in that segment earnings exclude certain operational expenses included in other expense net as reported. Management believes segment earnings to be a useful measure as it reflects the results of segment performance over which management has direct control and is used by management in its evaluation of segment performance. See Note 12. Segment Reporting, to our unaudited financial statements in Part I, Item 1 of this Quarterly Report for further information on the Company's reportable segments and for the reconciliation of segment earnings to net earnings.

**Infrared Optics (\$000's)**

|                         | <b>Three Months Ended<br/>September 30,</b> |             | <b>%</b>        |
|-------------------------|---------------------------------------------|-------------|-----------------|
|                         | <b>2011</b>                                 | <b>2010</b> | <b>Increase</b> |
| <b>Bookings</b>         | \$ 51,098                                   | \$ 41,302   | 24%             |
| <b>Revenues</b>         | \$ 50,796                                   | \$ 41,226   | 23%             |
| <b>Segment earnings</b> | \$ 12,357                                   | \$ 8,648    | 43%             |

The Company's Infrared Optics segment includes the combined operations of Infrared Optics and HIGHYAG.

Bookings for the three months ended September 30, 2011 for Infrared Optics increased 24% to \$51,098,000, compared to \$41,302,000 for the same period last fiscal year. The increase in bookings for the three months ended September 30, 2011 compared to the same period last fiscal year was driven by higher demand for replacement optics used in high-power CO<sub>2</sub> laser systems. In addition, HIGHYAG recognized increased bookings as a result of the accelerated market growth and demand for one micron beam delivery components, particularly in Asia.

Revenues for the three months ended September 30, 2011 for Infrared Optics increased 23% to \$50,796,000 compared to \$41,226,000 for the same period last fiscal year. The increase in revenues for the three months ended September 30, 2011 compared to the same period last fiscal year was primarily due to higher shipment volume to both OEM and aftermarket customers, increased laser utilization and deployment of CO<sub>2</sub> laser systems worldwide. In addition, the continued adoption of HIGHYAG products into the one micron beam delivery market contributed to the revenue increase.

Segment earnings for the three months ended September 30, 2011 for Infrared Optics increased 43% to \$12,357,000, compared to \$8,648,000 for the same period last fiscal year. The increase in segment earnings for the three months ended September 30, 2011 compared to the same period last fiscal year was primarily due to the incremental margin realized on the segment's higher revenue levels as well as favorable operating leverage as revenues outpaced incremental operating costs. The increase in segment earnings was somewhat offset by higher share-based compensation expense during the current period as the Company continues to utilize share-based compensation to incentivize and retain employees.

**Table of Contents*****Near-Infrared Optics (\$000 s)***

|                         | <b>Three Months Ended<br/>September 30,</b> |             | <b>%</b>                       |
|-------------------------|---------------------------------------------|-------------|--------------------------------|
|                         | <b>2011</b>                                 | <b>2010</b> | <b>Increase<br/>(Decrease)</b> |
| <b>Bookings</b>         | \$ 38,374                                   | \$ 33,816   | 13%                            |
| <b>Revenues</b>         | \$ 38,110                                   | \$ 36,945   | 3%                             |
| <b>Segment earnings</b> | \$ 1,708                                    | \$ 6,881    | (75)%                          |

The Company's Near-Infrared Optics segment includes the combined operations of VLOC, Photop and Aegis. The above results include Aegis for the three months ended September 30, 2011 only, as this acquisition was completed in July 2011.

Bookings for the three months ended September 30, 2011 for Near-Infrared Optics increased 13% to \$38,374,000, compared to \$33,816,000 for the same period last fiscal year. Excluding the impact of Aegis, bookings remained consistent with the same period last fiscal year as Photop and VLOC have experienced softening demand in the telecommunications and military markets, respectively.

Revenues for the three months ended September 30, 2011 for Near-Infrared Optics increased 3% to \$38,110,000, compared to \$36,945,000 for the same period last fiscal year. Excluding the impact of Aegis, revenues decreased during the three months ended September 30, 2011 when compared to the same period last fiscal year. This decrease is mostly due to lower levels of revenue at VLOC as activity with current military customers for contract research and development and the UV Filter product line have declined due to military budget constraints and uncertainty in regard to funding levels.

Segment earnings for the three months ended September 30, 2011 for Near-Infrared Optics decreased 75% to \$1,708,000, compared to \$6,881,000 for the same period last fiscal year. The decrease in segment earnings for the three months ended September 30, 2011 compared to the same period last fiscal year is due to a number of factors. Specifically, the Photop business unit experienced a decline in gross margin resulting from an unfavorable product mix as telecommunication product sales with higher margin profiles have declined during the current quarter. In addition, Photop and Aegis continued to invest in internal research and development for telecommunication product offerings. Furthermore, the VLOC business unit had an unfavorable change in earnings as a result of the declining revenues related to military contract research and development and UV Filter products.

***Military & Materials (\$000 s)***

|                         | <b>Three Months Ended<br/>September 30,</b> |             | <b>%</b>                       |
|-------------------------|---------------------------------------------|-------------|--------------------------------|
|                         | <b>2011</b>                                 | <b>2010</b> | <b>Increase<br/>(Decrease)</b> |
| <b>Bookings</b>         | \$ 19,801                                   | \$ 15,271   | 30%                            |
| <b>Revenues</b>         | \$ 23,659                                   | \$ 20,135   | 18%                            |
| <b>Segment earnings</b> | \$ 2,962                                    | \$ 3,721    | (20)%                          |

The Company's Military & Materials segment includes the combined operations of EEO, PRM, and MLA. The above results include MLA for the three months ended September 30, 2011 only, as this acquisition was completed in December of 2010.

Bookings for the three months ended September 30, 2011 for Military & Materials increased 30% to \$19,801,000 compared to \$15,271,000 for the same period last fiscal year. Excluding the impact of MLA, the increase in bookings for the three months ended September 30, 2011 compared to the same period last fiscal year was the result of strengthening demand and pricing for both selenium and tellurium driven by the Chinese market.

Revenues for the three months ended September 30, 2011 for Military & Materials increased 18% to \$23,659,000, compared to \$20,135,000 for the same period last fiscal. Excluding the impact of MLA, the increase in revenues for the three months ended September 30, 2011 compared to the same period last fiscal year was primarily due to higher shipment volume of selenium and tellurium at PRM.



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Segment earnings for the three months ended September 30, 2011 for Military & Materials decreased 20% to \$2,962,000, compared to \$3,721,000 for the same period last fiscal year. The decrease in segment earnings for the three months ended September 30, 2011 compared to the same period last fiscal year was primarily due to higher raw material pricing for selenium and tellurium which unfavorably impacted gross margin at PRM. In addition, earnings at PRM were negatively impacted by inventory write-downs caused by the volatility in material index pricing of tellurium as well as the recording of a bad debt provision resulting from a bankruptcy by a customer in the solar industry.

### Advanced Products Group (\$000 s)

|                         | Three Months Ended<br>September 30, |           | %<br>Increase<br>(Decrease) |
|-------------------------|-------------------------------------|-----------|-----------------------------|
|                         | 2011                                | 2010      |                             |
| <b>Bookings</b>         | \$ 20,974                           | \$ 21,661 | (3)%                        |
| <b>Revenues</b>         | \$ 25,808                           | \$ 21,828 | 18%                         |
| <b>Segment earnings</b> | \$ 6,008                            | \$ 3,411  | 76%                         |

The Company's Advanced Products Group (formerly, Compound Semiconductor Group) includes the combined operations of Marlow, WBG and WMG.

Bookings for the three months ended September 30, 2011 for the Advanced Products Group decreased 3% to \$20,974,000, compared to \$21,661,000 for the same period last fiscal year. The decrease in bookings for the three months ended September 30, 2011 compared to the same period last fiscal year was due to lower bookings at the WBG business unit caused by an early receipt of a periodic blanket order that was pulled into fiscal year 2011. The decrease in bookings was partially offset by increased bookings at Marlow primarily driven by the gesture recognition product line.

Revenues for the three months ended September 30, 2011 for the Advanced Products Group increased 18% to \$25,808,000 compared to \$21,828,000 for the same period last fiscal year. The increase in revenues for the three months ended September 30, 2011 compared to the same period last fiscal year was primarily due to higher shipment volume related to the gesture recognition product line at Marlow as well as increased shipment volumes at WBG for silicon carbide products due to accelerated demand within defense and commercial applications.

Segment earnings for the three months ended September 30, 2011 increased 76% to \$6,008,000, compared to \$3,411,000 for the same period last fiscal year. The improvement in segment earnings for the three months ended September 30, 2011 compared to the same period last fiscal year was primarily due to the increased margins realized from the additional revenues at both WBG and Marlow. In addition, the continued utilization of Marlow's Vietnam facility also favorably impacted segment earnings due to the lower operating cost structure of Vietnam.

**Table of Contents****Liquidity and Capital Resources**

Historically, our primary source of cash has been provided through operations. Other sources of cash include proceeds received from the exercises of stock options and long-term borrowings. Our historical uses of cash have been for capital expenditures, purchases of businesses, payment of principal and interest on outstanding debt obligations and purchases of treasury stock. Supplemental information pertaining to our sources and uses of cash for the periods indicated is presented as follows:

**Sources (uses) of Cash: (\$000)**

|                                                     | <b>Three Months Ended<br/>September 30,</b> |             |
|-----------------------------------------------------|---------------------------------------------|-------------|
|                                                     | <b>2011</b>                                 | <b>2010</b> |
| <b>Net cash provided by operating activities</b>    | 14,290                                      | 11,060      |
| <b>Proceeds from long-term borrowings</b>           | 7,000                                       |             |
| <b>Proceeds from exercises of stock options</b>     | 179                                         | 859         |
| <b>Purchase of business, net of cash acquired</b>   | (46,141)                                    |             |
| <b>Additions to property, plant &amp; equipment</b> | (12,712)                                    | (5,281)     |
| <b>Payment on long-term borrowings</b>              | (1,295)                                     |             |
| <b>Investment in unconsolidated business</b>        |                                             | (1,180)     |

Historically, during the first quarter of each fiscal year, cash generated from operations is at its lowest level due to the pay-out of the Company's worldwide bonuses accrued from the previous fiscal year. Cash provided by operating activities was \$14,290,000 for the three months ended September 30, 2011 compared to \$11,060,000 for the same period last fiscal year. The increase in cash provided by operations for the three months ended September 30, 2011 compared to the same period last fiscal year was primarily the result of higher non-cash adjustments for depreciation, amortization and share-based compensation expenses as net earnings and overall working capital requirements were consistent with the same period last fiscal year.

Net cash used in investing activities was \$58,830,000 for the three months ended September 30, 2011 compared to net cash used of \$6,244,000 for the same period last fiscal year. The majority of the increase in net cash used in investing activities was the result of the acquisition of Aegis in July 2011 as well as increased capital spending to support the Company's efforts to expand capacity to meet business requirements.

Net cash provided by financing activities during the three months ended September 30, 2011 mostly consisted of net long-term borrowings of \$5,705,000 to support the Company's working capital requirements.

In June 2011, the Company replaced its existing credit facility that was set to expire. The new credit facility is a \$50.0 million unsecured line of credit which, under certain conditions, may be expanded to \$80.0 million. The new credit facility has a five-year term through June 2016, and has interest rate of LIBOR, as defined in the agreement, plus 0.625% to 1.50%. Additionally, the facility is subject to certain covenants, including those relating to minimum interest coverage and maximum leverage ratios. As of September 30, 2011, the Company was in compliance with all financial covenants.

The Company's cash position, borrowing capacity and debt obligations for the periods indicated were as follows (\$000's):

|                                     | <b>September 30,<br/>2011</b> | <b>June 30,<br/>2011</b> |
|-------------------------------------|-------------------------------|--------------------------|
| <b>Cash and cash equivalents</b>    | \$ 110,786                    | \$ 149,460               |
| <b>Available borrowing capacity</b> | 27,100                        | 34,100                   |
| <b>Total debt obligation</b>        | 25,902                        | 18,729                   |

The Company believes cash flow from operations, existing cash reserves and available borrowing capacity will be sufficient to fund its working capital needs, capital expenditures, debt payments and internal growth for the remainder of fiscal year 2012.



**Table of Contents****Contractual Obligations**

The following table presents information about our contractual obligations and commitments as of September 30, 2011.

**Tabular-Disclosure of Contractual Obligations**

| Contractual Obligations<br>(\$000)                                      | Total      | Payments Due By Period |              |              |                      |
|-------------------------------------------------------------------------|------------|------------------------|--------------|--------------|----------------------|
|                                                                         |            | Less Than 1<br>Year    | 1-3<br>Years | 3-5<br>Years | More Than 5<br>Years |
| Long-Term Debt Obligations                                              | \$ 25,902  | \$ 3,902               | \$           | \$ 22,000    | \$                   |
| Interest Payments <sup>(1)</sup>                                        | 934        | 216                    | 359          | 359          |                      |
| Capital Lease Obligations                                               |            |                        |              |              |                      |
| Operating Lease Obligations                                             | 44,801     | 6,599                  | 10,396       | 7,179        | 20,627               |
| Purchase Obligations <sup>(2)</sup>                                     | 40,242     | 28,626                 | 11,442       | 174          |                      |
| Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet |            |                        |              |              |                      |
| Total                                                                   | \$ 111,879 | \$ 39,343              | \$ 22,197    | \$ 29,712    | \$ 20,627            |

(1) Variable rate interest obligations are based on the interest rate in place at September 30, 2011.

(2) A purchase obligation is defined as an agreement to purchase goods or services that is enforceable and legally binding on the Company and that specifies all significant terms, including fixed or minimum quantities to be purchased; minimum or variable price provisions, and the approximate timing of the transaction. These amounts are primarily comprised of open purchase order commitments to vendors for the purchase of supplies and materials and unpaid purchase prices for the Company's acquisitions of Photop and HIGHYAG.

The gross unrecognized income tax benefits under FIN 48 at September 30, 2011, which are excluded from the table above is \$5.4 million. The Company is not able to reasonably estimate the amount by which the liability will increase or decrease over time; however, at this time, the Company does not expect a significant payment related to these obligations within the next year.

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK****Foreign Exchange Risks**

The Company is exposed to market risks arising from adverse changes in foreign currency exchange rates and interest rates. In the normal course of business, the Company uses a variety of techniques and derivative financial instruments as part of its overall risk management strategy primarily focused on its exposure to the Japanese Yen. No significant changes have occurred in the techniques and instruments used other than those described below.

The Company also has transactions denominated in Euros and British Pounds. Changes in the foreign currency exchange rates of these currencies had an immaterial impact on the results of operations for the three months ended September 30, 2011.

In the normal course of business, the Company enters into foreign currency forward exchange contracts with its banks. The purpose of these contracts is to hedge ordinary business risks regarding foreign currencies on product sales. Foreign currency exchange contracts are used to limit transactional exposure to changes in currency rates. The Company enters into foreign currency forward contracts that permit it to sell specified amounts of foreign currencies expected to be received from its export sales for pre-established U.S. dollar amounts at specified dates. The forward contracts are denominated in the same foreign currencies in which export sales are denominated. These contracts provide the Company with an economic hedge in which settlement will occur in future periods and which otherwise would expose the Company to foreign currency risk. The Company monitors its positions and the credit ratings of the parties to these contracts. While the Company may be exposed to potential losses due to risk in the event of non-performance by the counterparties to these financial instruments, it does not anticipate such losses. The Company currently has a 300 million Yen loan to help minimize the foreign currency exposure in Japan. A change in the interest rate of 1% for this Yen loan would have changed the interest expense by an immaterial amount and a 10% change in the Yen to dollar exchange rate would have changed revenues in the range from a decrease of \$0.9 million to an increase of \$1.1 million for the three months ended September 30,

2011.

For II-VI Singapore Pte., Ltd. and its subsidiaries, II-VI Suisse S.a.r.l., PRM and AOFR Pty. Ltd., the functional currency is the U.S. dollar. Gains and losses on the remeasurement of the local currency financial statements are included in net earnings. Foreign currency remeasurement gains were \$0.3 million and \$0.1 million for the three months ended September 30, 2011 and 2010, respectively.

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For all other foreign subsidiaries, the functional currency is the local currency. Assets and liabilities of those operations are translated into U.S. dollars using period-end exchange rates while income and expenses are translated using the average exchange rates for the reporting period. Translation adjustments are recorded as accumulated other comprehensive income within shareholders' equity.

## **Interest Rate Risks**

As of September 30, 2011, the total borrowings of \$25.9 million were from a loan of \$3.9 million denominated in Japanese Yen and a line of credit borrowing of \$22.0 million denominated in U.S. dollars. As such, the Company is exposed to market risks arising from changes in interest rates. A change in the interest rate of these borrowings of 1% would have had an immaterial impact on the Company's financial results for the quarter ended September 30, 2011.

## **Item 4. CONTROLS AND PROCEDURES**

The Company's management evaluated, with the participation of Francis J. Kramer, the Company's President and Chief Executive Officer, and Craig A. Creaturo, the Company's Chief Financial Officer and Treasurer, the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this quarterly report on Form 10-Q. The Company's disclosure controls were designed to provide reasonable assurance that information required to be disclosed in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. It should be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. However, the controls have been designed to provide reasonable assurance of achieving the controls' stated goals. Based on that evaluation, Messrs. Kramer and Creaturo concluded that the Company's disclosure controls and procedures are effective at the reasonable assurance level as of the end of the period covered by this report. No changes in the Company's internal control over financial reporting were implemented during the Company's most recently completed fiscal quarter that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

## **PART II OTHER INFORMATION**

## **Item 1A. RISK FACTORS**

In addition to the risk factors and other information set forth in this report, carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended June 30, 2011, which could materially affect our business, financial condition or future results. The risks described below and in our Annual Report on Form 10-K are not the only risks facing the Company. Additional risks and uncertainties not currently known or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Despite our concerted effort to minimize risk to our production capabilities and corporate information systems and to reduce the effect of unforeseen interruptions to us through business continuity planning, we still may be exposed to interruptions due to catastrophe, natural disaster, pandemic, terrorism or acts of war, which are beyond our control such as the October 2011 flooding in Thailand. Disruptions to our facilities or systems, or to those of our key suppliers, could also interrupt operational processes and adversely impact our ability to manufacture our products and provide services and support to our customers. As a result, our business, results of operations or financial condition could be materially adversely affected.

On October 24, 2011, Fabrinet, a company that is used as a contract manufacturer of certain products of the Company and the Company's customers, announced that flood waters had infiltrated the manufacturing facilities at its Chokchai campus in Pathum Thani, Thailand. Fabrinet also announced that it has not yet been able to make a full assessment of the damage but believes that production will not recommence at Chokchai during the quarter ending December 31, 2011, and likely significantly longer, and Fabrinet acknowledged that it may never again manufacture at the Chokchai location. The Company is currently evaluating the situation to determine whether this event will have a material adverse impact on its future results of operations.

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**Item 6. EXHIBITS**

| <b>Exhibit Number</b> | <b>Description of Exhibit</b>                                                                                                                                                                                         | <b>Reference</b> |
|-----------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------|
| 31.01                 | Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, and Section 302 of the Sarbanes-Oxley Act of 2002                                         | Filed herewith.  |
| 31.02                 | Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, and Section 302 of the Sarbanes-Oxley Act of 2002                                         | Filed herewith.  |
| 32.01                 | Certification of the Chief Executive Officer pursuant to Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. § 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Filed herewith.  |
| 32.02                 | Certification of the Chief Financial Officer pursuant to Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. § 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Filed herewith.  |
| 101                   | Interactive Data File*                                                                                                                                                                                                |                  |

\* In accordance with Rule 406T of Regulation S-T promulgated by the Securities and Exchange Commission, Exhibit 101 is deemed not filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

II-VI INCORPORATED  
(Registrant)

Date: November 8, 2011

By: /s/ Francis J. Kramer  
Francis J. Kramer  
President and Chief Executive Officer

Date: November 8, 2011

By: /s/ Craig A. Creaturo  
Craig A. Creaturo  
Chief Financial Officer and Treasurer

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