CABOT MICROELECTRONICS CORPORATION
FOURTH QUARTER FISCAL 2018 CONFERENCE CALL SCRIPT
October 25, 2018

Good morning. With me today are David Li, President and CEO, and Scott Beamer, Vice President and CFO.

Last night we reported results for our fourth quarter and full fiscal year 2018, which ended September 30, 2018. Whether you're joining us online or over the phone, we encourage you to review the investor slide presentation that we've made available under the Quarterly Results section of the Investor Relations center on our website, cabotcmp.com.

A webcast of today's conference call and the script of this morning's prepared comments will also be available on our website shortly after this live conference call. You may request any of the information by calling our investor relations office at 630-499-2600.

Please remember that our discussions today may include "forward-looking statements" that involve a number of risks, uncertainties and other factors that could cause actual results to differ materially from these forward-looking statements. These risk factors are discussed in our SEC filings, including our Form 10-K for the fiscal year ended September 30, 2017. We assume no obligation to update any of this forward-looking information.

Also, our remarks this morning reference non-GAAP financial measures. Our earnings release and slide presentation include a reconciliation of GAAP to non-GAAP financial measures. Additionally, data is represented by rounded values throughout this discussion and in the supporting materials.

I would also like to inform you that Cabot Microelectronics has filed a Form S-4 registration statement with the SEC that includes a proxy statement/prospectus regarding the KMG transaction. You are urged to read the proxy statement/prospectus and other documents relating to the transaction because they will contain important information about the transaction. In addition, Cabot Microelectronics and KMG and their directors and officers may be deemed to be participating in a solicitation of proxies in favor of the proposed transaction.

You can find information about the Cabot Microelectronics and KMG directors and executive officers in each company's proxy statement filed with the SEC. You may obtain a copy of these documents through the SEC's website, the Cabot Microelectronics' and KMG websites or by requesting a copy from either company's investor relations department.

I will now turn the call over to Dave.

Thanks, Colleen. Good morning, everyone, and thanks for joining us.

Last night we announced record quarterly and annual results for revenue, gross margin, net income and earnings per share for our fourth quarter and full fiscal year 2018.

Fourth quarter revenue increased 15% while adjusted earnings per share were up 38%, as compared to the same period last year. This is the sixth consecutive quarter of record revenue for the company.

Our full-year revenue was up 16% over fiscal 2017, which we believe reflects growth well above that of the semiconductor industry. Our profitability has also improved significantly, with record gross margins contributing to record net income and earnings per share in fiscal 2018. This is our fourth consecutive year of record earnings per share and second consecutive year of record revenue.

We believe that achieving record financial performance in fiscal years 2015 through 2018 is evidence of the strength of our consumables-based business model, our continued technology leadership, and a strong industry demand environment. We are proud of our sustained performance, which we believe is the result of successful execution of our strategic initiatives. This has allowed us to achieve our stated corporate objectives to expand profitability and grow revenue faster than the industry.

Scott will provide additional details about our financial results later in the call.

I will now turn to our view of the global semiconductor industry environment. On the memory side, some recent reports have indicated that softening memory chip prices have caused certain customers to delay capital equipment purchases related to future capacity expansions. Further, on the logic side, several major logic and foundry customers have noted delays or difficulties in achieving further shrinks to smaller technology nodes. Within this environment, it is important to remember that our customers continue to operate their factories at nearly full utilization which supports our consumables-based business model. As Scott will discuss, we are seeing increases in demand for our products in our current quarter coming off this sixth record quarter.

We currently expect solid demand for our products to continue as we consider our outlook for fiscal 2019. We remain optimistic about long-term industry growth potential with higher demand for both memory and logic applications. Our products support increasing storage and processing power requirements to enable existing and emerging applications such as internet of things, autonomous driving, industrial automation, cloud and high-performance computing, virtual reality, and 5G.

In addition to these favorable industry trends, we continue to benefit from the 2D to 3D NAND memory conversion, which requires approximately twice the number of CMP steps. We believe the transition is still approximately 50% to 60% complete, which should provide a continued revenue tailwind in the next few years. We also expect to benefit from customer transitions to advanced logic architecture and the next generation of 3D memory, which also requires additional CMP steps and should remain a demand driver for our slurry solutions for the foreseeable future.

Now let me provide some details around our key product area performance in the quarter and full fiscal year

We reported record results for the fourth quarter and full year in all three key product areas - tungsten slurries, dielectrics slurries, and CMP pads.

Our tungsten slurry revenue increased 10% versus the same quarter last year and was up 14% for the full year. This growth was primarily driven by winning solutions for 3D NAND applications at leading memory customers, as well as advanced logic applications.

In dielectrics slurries, revenue increased 12% versus the same quarter last year, and was up 16% in fiscal 2018 versus the prior year. In addition to benefiting from higher overall demand from memory customers, advanced dielectric slurries grew as a result of the successful adoption of our colloidal silica and ceria-based solutions for advanced applications, as well as several notable competitive displacements that we have previously discussed. These are higher performance, higher margin products that provide lower total cost of ownership to our customers. We expect the transition from legacy to advanced dielectrics products to continue into fiscal 2019, adding to our revenue growth and margin improvement.

Turning to CMP pads, revenue increased 26% year over year to a new record level in the quarter. Pads revenue increased 21% to $83 million for the full year, maintaining the trajectory to reach our goal of at least $100 million in annual revenue by the end of fiscal 2019. We expect customer adoption of our NexPlanar product line to remain strong into fiscal 2019, and we are happy to report new win with a major memory manufacturer, which we expect will benefit revenue growth in fiscal 2019.

Looking ahead, we are excited about the continued strength of our core businesses. Our tungsten slurries, dielectrics slurries and CMP pads continue to benefit from our technology leadership, our refreshed product offerings, and the transition to advanced customer applications.

Lastly, I want to provide an update on our pending acquisition of KMG Chemicals. We continue to be enthusiastic about the transaction as we prepare to welcome KMG's global employees to our team, as well as add their products and technologies to our portfolio. We believe the addition of KMG's Electronic Chemicals business, will position us as the premier electronic materials supplier to the industry - providing enabling materials to nearly every critical process step in the fab; which will allow us to better address customers' challenges as well as inform our own future development and commercial efforts.

In addition, KMG's Performance Materials business is expected to provide additional opportunities to expand our addressable market with several highly attractive, highly profitable, leading specialty materials. In particular, KMG's pipeline performance business provides critical materials that enable enhanced customer efficiency and throughput in the fast-growing oil pipeline industry.

The KMG shareholder meeting to approve the transaction is scheduled for November 13. Assuming KMG shareholder approval and the satisfaction of remaining closing conditions, we expect to close the acquisition around November 16. The combination of these two world class companies represents vast opportunities and we believe that our customers, employees and shareholders will benefit from this acquisition.

And with that, I will turn the call over to Scott to provide more details on our financial results.

Thanks, Dave, and good morning everyone.

My comments will generally follow the related slide presentation we posted on our website last night, along with our press release.

Let's start with an overview of our financial performance this quarter, which is provided on slide 3.

Revenue for the fourth quarter of fiscal 2018 was a record $157 million, which is $20 million, or 15% higher than the same quarter last year. As Dave mentioned, the increase was driven by continued strong semiconductor industry demand and the focus on our three key product areas.

Sequentially, total revenue increased $6 million or 4%, with IC CMP consumables revenue up 2%. While solid overall, fourth quarter revenue was negatively impacted by a typhoon in Japan in September, and the timing of some customer shipments that shifted from the September quarter into the December quarter.

Our Net Income of $48 million was also a record, and represented an increase of $22 million, or 82% over the same quarter last year. This was driven by higher revenues, increased gross margin and a tax benefit, partially offset by an increase in operating expenses, primarily related to the KMG acquisition. Excluding acquisition-related expenses, NexPlanar amortization and tax adjustments, non-GAAP Net Income was $39 million, up 41% over the same quarter last year.

Our full-year revenue of $590 million was a record and an increase of 16% while IC CMP consumables revenue was up 15%, well above industry growth.

Full-year Non-GAAP Net Income increased 50% to $137 million, driven by strong revenue growth, improved gross margins and strong operating leverage.

Now let’s drill down into revenue, which is shown on slide 4.

As previously stated, we define tungsten slurries, dielectric slurries and polishing pads as three key product areas that are strategically important to us. During the quarter, these accounted for approximately 80% of total revenue, and I’ll mention each in order:

Tungsten revenue was a record $65 million, an increase of 10% compared to the same quarter last year.

Dielectrics slurries also delivered record revenue of $37 million, up 12% from the same quarter a year ago.

Sales of polishing pads were a record $22 million, up 26% compared to the same quarter last year.

Sales of slurries for polishing metals other than tungsten, including copper, aluminum and barrier, represented $18 million, an increase of 10% from the same quarter last year.

Finally, revenue from our Engineered Surface Finishes products, which includes QED, Data Storage, and Electronic Substrates was $14 million, a record level and up approximately 40% from the same quarter last year.

Now please refer to slide 5, which provides some higher-level P&L comparisons.

Gross margin for the quarter was a record 53.8%, compared to 51.2% in the same quarter a year ago. Excluding $1.3 million of amortization expense related to the NexPlanar acquisition, gross margin was 54.7%. Gross margin benefited from leverage
on higher volumes across all product lines, increased selling prices, and mix improvement, primarily in tungsten and dielectrics slurries.

For the full-year 2018 gross margin was 53.2%, compared to 50.1% last year. This includes an adverse impact of $5.2 million related to NexPlanar amortization expense. Gross margin came in slightly above our full-year guidance of 52% to 53%. Our gross margin improvement was primarily driven by leverage on higher volumes and mix improvement in tungsten and dielectrics product areas, partially offset by higher fixed costs to support the growth.

Operating expenses, which include research, development and technical, as well as selling and marketing, and general and administrative costs, were $40 million this quarter, an increase of $3 million over the same quarter a year ago. This primarily reflects acquisition-related expenses and excluding those, operating expenses were $36 million, actually a decrease of $1 million versus prior year.

Full-year operating expenses were $154 million, which is within our guidance, and an increase of $12 million primarily due to executive officer transitions and costs related to the pending KMG acquisition. As a percent of revenue, our full-year operating expenses declined to 26%, compared to 28% last year. Excluding the $4 million in acquisition-related costs, our full year operating expenses would have been $150 million, which would have been at the lower end of our range.

Our operating margin was 28.1% in the quarter, an increase of 390 basis points from the same quarter last year. Excluding Nexplanar amortization and KMG acquisition-related expenses, operating margin expanded 630 basis points to 31.7%. This increase was driven by higher gross margins and prudent control of core operating expenses.

We recorded a tax benefit in the quarter as we adjusted our previously recorded reserves related to US tax reform, but excluding the adjustments, the effective tax rate was 23.3%, which was within our expectation of 21-24%.

Diluted EPS was $1.84 this quarter, which was also a record, and represents an increase of 79% over the prior year quarter. Diluted EPS on a non-GAAP basis was $1.48, also a record and an increase of 38% over the prior year. This was primarily driven by higher revenue,higher gross margins and prudent cost control.

Full-year adjusted EPS was $5.22, a 47% increase over the same period last year.

Now please refer to slide 6, which provides balance sheet and cash flow information.

We generated cash flow from operations of $65 million. We ended the quarter with a cash balance of $353 million and no debt outstanding.

We have discussed the pending acquisition of KMG Chemicals, and we will partially finance the transaction through Term Loan B debt of approximately $1.1 billion.

Capital spending for the quarter was $6 million, bringing our year to date total to $21 million. During the quarter, we continued to invest in our pads operations to improve automation, throughput, and efficiency to support continued increasing customer demand.

Accordingly, our free cash flow was $59 million in the quarter, and $148 million for the full fiscal year.

As previously communicated, our intention has been to return at least 50% of our prior year's free cash flow to shareholders by way of dividends and share repurchases. During fiscal 2018, we returned $72 million, or 60% of prior year's free cash flow, so we have exceeded that target.

Now please refer to slide 7 for a list of important milestones for the pending KMG acquisition. We are pleased with the progress and anticipate closing around November 16. We have earned public debt ratings of BB+ on our upcoming Term Loan B from S&P and a Ba2 rating from Moody's. We are currently in the marketing period for our debt.

We provide some closing remarks on slide 8 and fiscal first quarter and full-year 2019 financial guidance on slide 9.

From a financial perspective, we achieved very strong performance this quarter and this fiscal year, including record revenue, net income and EPS, and I would like to highlight the operating leverage we are seeing on revenue growth. In the fourth quarter, revenue increased $20 million from the prior year while operating expenses decreased and operating income increased $15 million excluding acquisition-related expenses. This implies that approximately three quarters of our incremental revenue dropped directly to operating income. Year to date, our sales increased $83 million while operating income, excluding acquisition-related expenses, increased $52 million, implying a full year operating leverage rate of 63%.

For expectations, I will address our current business only, and these will not represent expectations for total results once we close the KMG acquisition. Moving forward, we expect to report results for at least two reporting segments like KMG's structure today. We will provide further information at the appropriate time after closing the transaction.

At the highest level, we remain confident in our ability to grow revenue faster than the semiconductor industry and to continue to improve margins during fiscal 2019.

For the first quarter of fiscal 2019, we expect our IC CMP consumables business to show a low- to mid-single digit increase sequentially compared to our record fourth quarter 2018 results. Given mixed commentary about operating conditions by some players in the industry, we would like to emphasize the resilience of our consumables-based business.
As we think about the full year fiscal 2019, we expect solid demand conditions for our products. At the same time, we will continue to focus on operating expenses and further improving the profitability of our business.

We currently expect full fiscal year gross margin to be between 53% and 55% on a GAAP basis compared to 53.2% reported in fiscal 2018. This guidance includes $5.2 million of NexPlanar amortization expense.

We also expect our operating expenses for the full fiscal year to be between $154 and $158 million, compared to $150 million reported in fiscal 2018, excluding acquisition-related expenses. Again, this guidance does not include any potential KMG acquisition-related expenses.

We expect our effective tax rate to be in the range of 21%-24%, while our capital spending expectation for the full fiscal year is between $23 and $26 million, an increase from the prior year as we continue to invest in organic growth for our company.

In summary, we have delivered strong financial performance, including record revenue, gross margin, net income, and earnings per share for our fourth quarter and full fiscal 2018, which we believe demonstrates the continued focus on execution of our strategic initiatives. For fiscal 2019, we remain confident in our ability to drive continued revenue growth, improve gross margin performance and maintain disciplined management of operating costs, which should result in net income growth. We look forward to building on our success by combining Cabot Microelectronics' with KMG to provide innovative, high quality solutions that solve our customers' most demanding challenges.

Now I'll turn the call back to the operator, as we prepare to take your questions.

That is all the questions we have this morning. Thank you for your time and your interest in Cabot Microelectronics.