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ADV.DE - Q2 2016 Adva Optical Networking SE Earnings Call

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PRESENTATION

Operator

Dear ladies and gentlemen, welcome to the Q2 2016 IFRS Financial Results Conference Call of ADVA Optical Networking. This call is being recorded. As reminder, all participants will be in a listen only mode. After the presentation, there will be an opportunity to ask questions.

[Operator Instructions]

I now hand over to Mr. Stephan Rettenberger, ADVA Optical Networking's Vice President, Marketing and Investor Relations. Please go ahead sir.

Stephan Rettenberger - *ADVA Optical Networking - VP, Marketing and Investor Relations*

Thank you, and a warm welcome from my side. This earning call builds on a presentation which is available for download in pdf format from our home page under www.advaoptical.com in the About Us/Investor Relations section. Should you not have the presentation in front of you, you may want to access it on the conference call's page in the Financial Results section of our Investor Relations website.

Before we will lead you through the presentation, as always please be informed that this presentation contains forward looking statements with words such as believes, anticipates, and expects to describe expected revenues and earnings, anticipated demand for Optical Networking solutions, internal estimates, and liquidity. These factors are discussed in greater detail in the Risk Reports section of our Annual Report 2015.

Please also be reminded that we provide consolidated performer financial results and this presentation solely as a supplemental financial information to help the financial community make meaningful comparisons of our operating results from one financial period to another. This proforma information is not prepared in accordance with IFRS and should not be considered a substitute for historical information presented in accordance with IFRS.

We will target to limit this con-call to 60 minutes and since Brian is traveling today we have a slightly different choreography in today's call. He's in a part of this world that does not have reliable phone connectivity and thus we do not want to take any chances. So Brian will only say a few welcoming words, after that I will provide the business update and outlook, and then Uli will talk us through our Q2 2016 financials. And finally, we will have sufficient time for your questions, which we'll be happy to answer, and again, where we hope to have Brian also on the line and participate.

So Brian, if you can hear us okay, please - a few words from your side.

Brian Protiva - *ADVA Optical Networking - CEO*



Hello to everybody, as Stephan said, I am traveling and not in good connectivity positions, so we didn't want to take any chances. I think that Stephan will do an excellent job taking care of the initial intro, business update, and outlook. I did work with him in detail on all of the content, so clearly there is no change to the content that we normally provide and I will be available for all the Q&A. If I get interrupted during the Q&A piece, clearly Stephan and Uli will cover for me and I would be right back on.

So hello to everybody, look forward to the con-call, and I will pass right back to Stephan.

Stephan Rettenberger - ADVA Optical Networking - VP, Marketing and Investor Relations

Thank you Brian. So let us start with the business update and outlook. We go to slide number 4, Q2 2016 in review. Revenues rose by 40.1%, versus the previous year's Q2, to EUR157.2 million. This result is slightly above the range of our Q2 guidance. Q2 pro forma operating income was at EUR4.2 million or 2.7% of revenues within our guidance, which we forecasted to be in the 1% to 4% range.

Importantly, this was our 10th consecutive quarter with year on year growth. We've protected our balance sheet in the first half of 2016, even with a large acquisition, and invested in growth. Q2 gross cash was at EUR82.5 million.

Our investments in open connectivity and networking solutions - which support the two megatrends, cloud and mobility - are driving rapid growth for ADVA Optical Networking. The success in the Data Center Interconnect space is allowing us to outperform the market when it comes to revenues.

We've almost completed the integration of Overture and the acquisition should start having a positive impact to our absolute EBIT in the second half of 2016. It will, however, take some time to drive revenues from our newly acquired Ensemble Software Solution in order to help the acquisition also support relative EBIT %age gains.

We now have to focus on profitable growth and drive greater leverage from higher revenues. We have made huge investments into technology over the last 24 months.

Turn to page 5. So what do our prospects for Q3 2016 look like? We continue to show strong revenue growth. In fact, our forecast shows that we should continue to grow at more than 25% year on year Q3, when considering the midpoint of our guidance. This growth has been generated by the transition to the cloud, by residential and enterprise users. The increase in number of customers through new wins and the many new customers we added through the Overture acquisition.

When looking at the regional breakdown, we see real strength in North America and in some parts of Europe. Whereby all target application segments are demonstrating growth, especially Metro 100G investments, and Data Center Interconnect opportunities.

We will continue to focus on innovation as major transformations such as cloud, software defined networking, network functions virtualization, and 5G will allow for differentiated products and solutions to win market share.

In summary, we've been upgrading our entire product portfolio over the last months. We have very competitive solution platforms that enable us to win new footprint. Examples of this; our FSP 3000 CloudConnect, our FSP 150 Pro family, and the launch of our fully integrated Ensemble software framework. With the new product, strong markets, and more focus on operational expenses post our Overture acquisition, we will increase profitability in the second half of 2016. It will, however, be very challenging to show relative profitable growth in our EBIT numbers when compared to 2015.

Turn to page number 6. Innovation, innovation, innovation. As we have continued to present over the last years, innovation drives opportunity for ADVA. This opportunity will continue as long as we serve as fast moving and changing markets. Over the last 18 months we have not only been recognized by our shareholders, but also by one of the leading trade journals, online magazines, and event management companies in our industry: Light Reading.

We won their Leading Lights Public Company of the Year award. With the award, Light Reading recognized our financial success and key technology innovations. We won this award due to our results, vision, and industry position. Innovation plays a huge part of this election criteria to honor the public company of the year in our industry.

Continuing to page number 7. Connecting, extending, and assuring the cloud. This is our solution graphic here. During the recent years, the world of technology and communication has become far more mobile, cloud, and software oriented. But the foundations of success for virtualization, the cloud, and 5G, rests on the shoulders of high-speed fixed networks. There will be more fiber to more endpoints than ever before, supporting an average long-term bandwidth growth of 30% year over year.



With this backdrop, here is a brief summary of our application space. Starting on the right, you see our optical networking platform providing high speed connectivity between data centers and carrier hubs. Cloud services drive data center growth thus bandwidth demand and investment in optical capacity. The cloud interconnect demand comes from three user groups.

Lower right, you see the Enterprise and Fortune 500 company application with large scale needs for data storage, replication, and backup; labeled here with Business Continuity.

In the center, illustrating the Communications Service Providers, or carriers. These providers own large fiber plants, they have experience in design, building, and operating optical networks.

And on the upper right, the new players in the market - the Internet Content Providers or ICPs or web 2.0 companies that are in the business of creating, storing, and disseminating digital information.

All these markets are growing near and around the 10% compound annual growth rate mark. And with the ICP segment, that part is growing the fastest. We have good exposure and good differentiation in all three segments.

On the left side of the chart you see our Cloud Access Solution space, where our technology connects enterprise users, mobile base stations, and backhaul traffic from the residential access infrastructure. Thanks to the acquisition of Overture in Q1, we have a broader and deeper solution portfolio at the edge of the network than ever before; this new footprint and capabilities specifically in North America.

Last but not least, on top of this slide you see the new Ensemble software suite that we launched in Q1, the strategic reasoning behind our Overture acquisition. With Ensemble software you can use the cloud to deliver the cloud to the end customer. And I will talk more about this later. ADVA Optical Networking is growing its reach by connecting, extending, and assuring the cloud, so our customers can transform their networks.

We're going to page number 8. Data center interconnect and carrier infrastructure. Data centers, we stated before, are the cornerstones of our networked societies. Network upgrades and new builds go hand-in-hand with data center growth. Data Center Interconnect is actually where we come from, this is in our DNA. Our focus and competence in this space allow us to aggressively win new footprint and grow faster than the market.

And, as we already mentioned, our ability to innovate and outperform has not remained unnoticed. We won the prestigious Best Public Company Award from Light Reading - shown on an earlier slide - and also the Celtic-Plus Award for our contribution to the European SASER Project.

Through partnerships, we innovate along the entire value chain from components to systems, and we recently announced a couple of new customer wins, demonstrating that our new products are gaining traction and will allow us to drive growth through new wins.

And finally, we are using our technology to support new directions. TIP, the Telecom Infra Project, was co-founded by Facebook -- one of the most prominent web 2.0 companies - and operators such as Deutsche Telekom and South Korea Telecom. It is an engineering focused initiative that aims to re-imagine the traditional approach to building and deploying telecom network infrastructure.

We envisage ADVA being a leader and very responsive to these new directions as we're innovative, fast, and aggressive to adapt our strategic direction to support leading customers in our industry.

Going to page number nine, Cloud access and synchronization. As I said before, thanks to the acquisition of Overture in Q1 we have a market leading Ethernet access device product portfolio which was enhanced with Ethernet over copper technologies and strengthened with excellent engineering, and product skills from the Overture team, coupled with the most comprehensive and innovative business edge offering supporting the virtualized edge of the network.

The integration of Overture is progressing well and nearing completion. We have fully integrated their runway business into our cloud access portfolio and we are running dozens of proof of concepts and trials all set at tier one accounts. These accounts are distributed all over the globe, and will help us to realize a return on our investment.

In addition, we successfully introduced and rolled out our advanced link monitoring solution, which won us new tier one footprint, and another innovation award: the Global Telecoms Business Award that we won together with Verizon Solution Partners for wholesale service innovation. The jury honored the successful commercialization of Verizon Solution Partner's new Optical Wave Service, Optical Extension which leverages our ALM fiber monitoring solution.



As a reminder about the cloud access space, we believe that the \$1 billion layer 2 network interface device market, that we are addressing, is becoming a multibillion dollar cloud access market whereby layer 2 and layer 3 are converging, and our assurance solution will also help to further expand our total [adjustable] market. We have all the pieces to compete, and thus we are looking forward to the transformation taking place, unlike many incumbents who are trying to prevent the change.

Slide number 10. ADVA Ensemble, our cloud software. A few more words here on ADVA Ensemble, a new strategic division focused on network functions virtualization. Ensemble is our cloud software solution which we acquired as part of the Overture deal in Q1.

With Ensemble, ADVA can enable a service provider with limited data center infrastructure to build and deliver a complete cloud offering. This gives our telco customers the ability to simplify their network, yet still offer sophisticated services at the customer's fingertips. With Ensemble we enable our service providers' customers to connect their virtualized services across any cloud and with any hardware which you have in your network today.

Our solutions can work with thick or thin clients, white boxes, or legacy equipment. We allow our customers to extend the existing infrastructure by offering control over software applications, regardless of location. Those can be installed as close to the customer's sites as necessary or when needed for applications which are sensitive to latency or jitter. Security might be another parameter which is evaluated when deciding where to host those applications.

With Ensemble we make life simple for our customers, by allowing them to use the cloud to offer specific requirements with centralized and software driven processes. Ensemble enables you to use the cloud to deliver the cloud. These investments in the Ensemble software suite are costing us profitability, but they are positioning us to lead as the markets transform.

Slide number 11, ADVA Ensemble innovation awards. With ADVA Ensemble we have not only opened the doors to many relevant carrier accounts, we also created a lot of mindshare in the wider industry, winning multiple innovation awards with multiple categories. We enable our customers to rapidly bring new and differentiated services to market with both product innovation, and business service innovation. And you see a couple of those examples here summarized on slide 11.

With that, I'll hand it over to Uli who will lead you through the financial section.

Uli Dopfer - ADVA Optical Networking

Thank you Stephan and hello everybody. Let us start with the financial highlights for Q2 2016 according to IFRS. The pro forma numbers presented here are calculated prior to non-cash charges related to stock-based compensation, and amortization and impairment of goodwill and acquisition related intangible assets. Unless stated otherwise, all numbers are presented in Euro.

Slide 13 please. IFRS quarterly revenue and pro forma profitability. As already stated, we ended Q2 2016 with revenues of EUR157.2 million, being ADVA's strongest quarter ever. This result is slightly above our guidance of between EUR145 and EUR155 million, and represents a 40% increase year over year. Again, this marks the tenth consecutive quarter with year on year growth.

The increase in revenues was mainly driven by two factors; the demand for Data Center Interconnect technology, and the continued push for 100G in metro and regional networks. Due to the high revenue contribution of the ICP segment, relative gross profit was slower than Q2 2015, and stood at 27.3% of revenue.

Pro forma operating income in Q2 2016 was at EUR4.2 million or 2.7% of revenues. This is in line with our guidance of between 1 and 4% of revenues, and compares to 6.8% achieved in Q2 2015. These quarterly results include the acquisition of Overture from January 13 and consequently one-off restructuring and integration expenses related to this acquisition.

Let's move to the next slide, please. IFRS profitability below the pro forma operating income. In Q2 2016, IFRS operating income was at EUR3.1 million or 2% of revenues, down from EUR7.4 million or 6.6% in Q2 2015. Key drivers for this development are the aforementioned reasons for lower pro forma operating income, and higher amortization of intangible assets due to the Overture acquisition.

Our Q2 2016 net income was at EUR9.8 million or 6.2%. This result was impacted by positive FX effects caused by the strong US dollar at the end of June, and partially reversed the losses we experienced in the first quarter of 2016.

Also, we show positive one-time tax effects mainly due to the completion of the German tax audit for ADVA Optical Networking SE, and the release of a deferred tax liability for Overture networks. Looking at Q1 and Q2 in total, our net income is up to positive EUR4.6 million. As the number of weighted average shares outstanding has not changed significantly, diluted EPS developed in proportion with IFRS net income to EUR 0.20 a share.



Next slide, please; Quarterly revenues per region. In Q2 2016 EMEA recorded revenues of EUR69.5 million, a EUR5 million increase from the EUR64.1 million in the previous quarter and representing 44% of our total revenues. This is slightly below the EUR71.4 million achieved in Q2 2015.

Supported by both the Overture acquisition and strong revenues with internet content providers, the Americas managed to become the strongest region in Q2 2016, and with EUR79.5 million is showing an increase of 132% year over year.

Asia Pacific revenues were at EUR8.2 million or 5% of sales, a 24% increase year over year, and 26% compared to Q1 2016. We continue to gain footprint in the carrier and infrastructure segment in this region, particularly through the development of our successful 100G solutions. Due to the project nature of this business and the relatively small base we will continue to see volatility in the quarterly revenue development within this region.

Next slide please, IFRS consolidated balance sheet. Please note that the version of the slide deck that was uploaded this morning contained a typo in the text underneath the diagram on the lower right hand side. It has been corrected since. It shows, actually that our analysts pay attention to the slides we provided thanks Leo Bayer for pointing that out.

Overall networking capital at EUR102.7 million, is down from the EUR110.9 million reported at the end of Q1 2016. Although accounts receivables and payables increased due to our strong growth, we managed to reduce inventories significantly.

Trade accounts receivable at EUR112.0 million is up from EUR92.8 million at the end of Q1 2016, primarily due to the higher levels of revenue reported in Q2 2016. Trade accounts payable at EUR77.1 million increased from EUR57.8 million in the previous quarter.

We successfully managed our inventories, resulting in an inventory turn of 6.4, compared to 4.4 as seen at the end of Q1. Despite the significant growth in absolute numbers, both DSOs and DPOs slightly decreased in Q2 2016. Stockholders equity at EUR218.1 million is up from EUR207.5 million versus the end of last quarter. We continue to maintain a strong equity ratio of close to 50%.

Next slide please. IFRS consolidated cash flow. Cash flow from operating activities amounted to EUR22.4 million, up from the EUR18.1 million reported in Q2 2015, and the EUR2 million reported in Q1 2016. The increase from Q1 to Q2 is largely driven by net income and decrease in working capital.

Cash flow used to investing activities: After the acquisition of Overture impacted the investing cash flow significantly in Q1, we are back in Q2 at normal levels with an investing cash flow of EUR11.4 million.

Following the cash flow in Q4 2015 and Q1 2016, cash flow from financing activities in Q2 2016 was as at a negative EUR1.9 million mainly consisting of servicing existing loans. Accordingly, free cash flow came in at EUR19.0 million versus the negative EUR0.6 million reported in the previous quarter.

Now I would like to share our guidance for Q3 2016. Next slide please. We are committed to improving the stability and predictability of our business. As in the past, we will continue to provide protections for the current quarter only. Market growth drivers continue to be intact. Cloud and mobility continue to drive data center builds and expansions, thus driving demand for more interconnect capacity.

Our long-term growth prospects continue to be strong.

As previously communicated, there are both risks and opportunities in realizing revenue, particularly in the infrastructure business. We remain committed to a flexible cost and operating model that allows us to quickly adapt to changing market conditions. We will continue to drive operational efficiencies within all facets of our organization. We consequently protect Q3 2016 revenues of between EUR150 and EUR160 million, with Pro Forma operating income to range between 3 and 6% of revenue.

We will continue to perform detailed reviews of the expected business development in respect of all intangible assets, including capitalized development projects. In case of highly adverse business prospects, such review may result in non-cash impairment charges in Q3 2016 and beyond. The Pro Forma operating income guidance we have provided today excludes any such potential impairment charges. Next slide please.

Our summary of the presentation: Our strong top line growth continues, and we are building momentum. Our focus and competence in the DCI space allow us to outperform the market. We are aggressively growing our footprint in the space with a number of key customers, and we are continuing to win strategic accounts.

Integration of Overture is progressing well and nearing completion, we fully integrated the hardware business into our Cloud access portfolio, and significantly expanded our customer footprint. Innovation is more important than ever, and is helping to grow our market share. With the launch of Ensemble, the new strategic division focused on network functions utilization, we leapfrogged the market and are opening new doors. Now is the time to build strength and differentiation.



In Q2 alone, we won several awards as Stephan explained earlier that prove our ability to innovate and to increase mindshare with customers and partners. Thank you for your participation in today's call. And with that, I'd like to the call over to the operator to begin the Q&A session of the call.

QUESTION AND ANSWER

Operator

Thank you very much. Ladies and gentlemen, we are now starting the question-and-answer session.

[Operator Instructions]

Your questions will be answered in the order they are received. If you are using speaker equipment today, please lift your handset before making a selection. One moment please, for the first question. The first question comes from Mr. Alex Henderson [by] Needham. Please go ahead, sir.

Alex Henderson - Needham & Company - Analyst

Thank you very much. First question for you, given the supply challenges in the optical space, are you experiencing supply constraints, particularly on coherent modules and [DCO] mods?

Uli Dopfer - ADVA Optical Networking

Brian, do you want take this question? Or should we?

Brian Protiva - ADVA Optical Networking - CEO

I will, I will. Alex, we clearly withstood a fast growth. You have supply constraints. It's been a huge effort by operations teams to keep up with order flow. And yes, there are a number of different fronts, that we're challenged to keep up, but I think we've done a good job. And we haven't lost any customer opportunities or pushed anybody off to create tension in our customer relationships. So, it's working. It is very tight, but it is working.

Alex Henderson - Needham & Company - Analyst

Second question, if I could. The Overture acquisition, could you give us some sense of what the Pro Forma growth rate would have been had you had that in for the full year? Or alternatively, just back it out and what the traditional classic ADVA growth rate would [have] been, excluding the Overture acquisition?

Uli Dopfer - ADVA Optical Networking

So, if you would exclude the Overture acquisition from [my ADVA] numbers, you would have seen a similar profitability that we saw last year to this [date], maybe a little higher.

Alex Henderson - Needham & Company - Analyst

I'm more interested in the revenues than the profitability to be honest. [But] I'm trying to figure out what the baseline growth rate was.

Uli Dopfer - ADVA Optical Networking

So revenues, or do you mean organic growth?



Alex Henderson - Needham & Company - Analyst

Right.

Uli Dopfer - ADVA Optical Networking

OK. Organic growth would have been probably in the 22 to 24% range roughly.

Alex Henderson - Needham & Company - Analyst

22 to 24. And is that similar in the [forecast] - in the guide?

Uli Dopfer - ADVA Optical Networking

For Q3?

Alex Henderson - Needham & Company - Analyst

Right.

Uli Dopfer - ADVA Optical Networking

Pretty much. Maybe it's a little - [yes], [no] pretty much. Pretty much...

Brian Protiva - ADVA Optical Networking - CEO

Uli, let me just quantify that. Our growth rate in Q3 is not at the same rate as it is in Q2. We don't break out Overture revenues, but we do feel there's been a small uptick in Overture. What would be the growth rate if you backed that out. I mean, give a range, [just] 10 to 15% kind of forecasted revenue growth.

Alex Henderson - Needham & Company - Analyst

Great, thank you.

Brian Protiva - ADVA Optical Networking - CEO

Maybe a little bit more. Maybe it would be 15. Maybe 15...

[Multiple speakers]

Brian Protiva - ADVA Optical Networking - CEO

Maybe 15 to 20%. Put it in that range.

Uli Dopfer - ADVA Optical Networking



It's in that range, correct.

Alex Henderson - Needham & Company - Analyst

OK, two last quick questions. They were [very] - both asked. Why was Europe down? And was orders stronger in Europe? Can you explain that? And what was the growth rate in the DCI?

And then I'll cede the floor. Thank you very much.

Uli Dopfer - ADVA Optical Networking

So Europe is slightly down. It's more [a timing] issue of revenue, or [revenue recognition] issue that we see on a regular basis. It just was a deadlock so to speak that revenues were slightly down. So all the growth continues to be strong in Europe. And so there's no downtick or so to our orders.

Brian Protiva - ADVA Optical Networking - CEO

DCI growth?

Uli Dopfer - ADVA Optical Networking

DCI growth was significantly - I mean, now DCI is probably 25% of our overall revenue number. In the past these were in the 10 to 12% range.

Alex Henderson - Needham & Company - Analyst

Perfect. Thank you very much.

Operator: The next question comes from Mr. Oliver Pucker. Please go ahead, sir.

Oliver Pucker

Yes, good afternoon ladies and gentlemen. [I'm a part of Motorvet], and thank you for taking my question. Maybe we can go through the questions one by one. So my first question would be on the Q2 top line. So, if I got it correctly, you just answered the question.

So the Q2 revenue coming from ICP customers would be around 25% of this figure?

Uli Dopfer - ADVA Optical Networking

That's correct.

Oliver Pucker

Yes. And how much of that was coming from the Cloud Connect?

Uli Dopfer - ADVA Optical Networking

Cloud Connect number is in Q2. We have not seen - we [shipped] Cloud Connect, but we did not recognize any Cloud Connect revenues yet.



Oliver Pucker

OK

Uli Dopfer - ADVA Optical Networking

So, all the existing or current technology.

Oliver Pucker

OK. Maybe a follow up on the Cloud Connect. So the [ramp up] seems to be a little bit slower than expected. Do you have any visibility when your ICP customers will migrate to Cloud Connect?

Stephan Rettenberger - ADVA Optical Networking - VP, Marketing and Investor Relations

Brian, do you want to take this?

Brian Protiva - ADVA Optical Networking - CEO

Yes so, again, [we] as I said in Q2 we'd be shipping the product, we're shipping the product. The ramp up will be as I think indicated into multiple millions in Q3, and then really starting to have an impact in Q4. As indicated in our last quarter, our revenues have increased dramatically therefore introducing a new product [that's] less influence on \$150 million of revenue versus \$100 million. So I think that is part of the issue, but I think we feel very comfortable. We announced a new strategic ICP win based on the Cloud Connect.

We see business going forward. So, it's bigger picture, more revenues therefore the Cloud Connect will have less influence in this year. But it will be a successful product launch. And it will start to increase our gross margins in Q2, 3, slightly Q4 a little bit more, and then dominant in 2017.

Oliver Pucker

Great, OK. And in terms of profitability, you still stand by your statement that Cloud Connect will be significantly more profitable.

Uli Dopfer - ADVA Optical Networking

It's correct.

Brian Protiva - ADVA Optical Networking - CEO

Correct. And there's a combination of two issues there. One is that the Cloud Connect's cost platform for 100 G is dramatically different. That's key, and therefore going into existing customer base, we will be able to increase our margins. And then secondly is that we do believe we can win new accounts that help us grow dramatically, but also give us good margin contribution based on the costs of the platform.

Oliver Pucker

OK. Thank [for that]. And then maybe one follow-up question on Overture. Did I get this correct? So, should we expect any more integration costs in the second half of the year? And maybe if Overture now break even?

Uli Dopfer - ADVA Optical Networking



So, answer to the first question, as we explained earlier the integration is almost completed, so we're in line with all of our processes. [We] continue to integrate of course products going forward. But we would not see any costs going forward that we would consider as integration costs.

Oliver Pucker

OK.

Uli Dopfer - ADVA Optical Networking

Secondly, is it break even yet. We are fully in plan with what we planned in order to reduce cost. So, we achieved that goal but we do not break out P&L or any numbers, especially [in sort] since it's integrated, or partially integrated, and we actually broke out the [assortment] piece. So that's why we are going to lose that visibibility anyways.

[Multiple speakers]

Brian Protiva - ADVA Optical Networking - CEO

I would like to make one comment [there]. With the Overture acquisition, we had let's say existing Carrier Ethernet business. So it's helped us grow that [technical difficulty].

Stephan Rettenberger - ADVA Optical Networking - VP, Marketing and Investor Relations

I guess now we have a situation that the line is dead. Brian, can you hear us? No he can't. [Can Mary can't]...

Oliver Pucker

Maybe I will just continue with...

[Multiple speakers]

Uli Dopfer - ADVA Optical Networking

...maybe he comes back, and it's not....

[Multiple speakers]

Oliver Pucker

Maybe one question also on the Brexit. So we know that BT is one of your largest customers. So, what was the impact of the Brexit on your Q3 guidance?

Uli Dopfer - ADVA Optical Networking

So clearly, the Brexit as you know, BT is one of our largest customers.

Oliver Pucker

Yes.



Uli Dopfer - ADVA Optical Networking

So, it hurt us. And you would have seen a higher guidance if we would not have had the Brexit. So, you can anticipate probably - it depends on how the Pound develops. As of now, it would probably mean between one and two million less profitability. And this is pretty much what we have included in our guidance.

Oliver Pucker

OK, great. And maybe one final question on the tax rate. So you already commented on the significant positive effect of 4.7 million. Maybe can you explain [this effect] a little bit in more detail? And maybe also comment on what we should expect in terms of the full year tax rate?

Uli Dopfer - ADVA Optical Networking

So, sure. So, there's two aspects to this tax credit. One is we had a tax audit going on for the longest part since I'm with ADVA. So, it covers a period of 2003 through 2012. And we finally received at the end this Q2 quarter the notice from the German tax authorities.

They accepted [or the] with the result of the audit and which resided in a large credit on one hand. And the other part of the credit simply has to do with the Overture acquisition so we could release some [deferred] tax liabilities.

Oliver Pucker

OK, and..

Uli Dopfer - ADVA Optical Networking

And going forward, tax rate, I would anticipate, yes, a low tax rate. I mean, this was really extraordinary quarter [because] all these two pieces [slide] together. Going forward, I would still anticipate a low tax rate maybe in the higher one digit, or low double digit %age range.

Oliver Pucker

OK. Perfect. OK, thanks a lot.

Uli Dopfer - ADVA Optical Networking

Good.

Operator: The next question comes from Tim Savageaux. Please go ahead, sir.

Tim Savageaux

Hi, hello. Good morning slash afternoon. A couple of questions, first at a high level. I wonder if you can - in looking at the forecasted improvement in operating margins for Q3 on a revenue level that's pretty similar, would you attribute that to gross margins, recovering a bit, further operating expense declines, or how would you see that?

Uli Dopfer - ADVA Optical Networking

It's a combination. So, gross margins will go up. We will have a - of course, if our cost reductions efforts will pay off, we will probably have a slightly more favorable product in customer mix. But also lower operating expense. I mean, [we] mentioned earlier that the integration now is completed.



And we should not see these one-time effects that we saw in Q1 and Q2 based on the Overture acquisition.

Tim Savageaux

OK. And then, with regard to gross margins, looking at the data center Interconnect market in particular, it seems like it could be the case that you're shipping current platform kind of at future prices if you will. Which is to say to the extent some of these stand-alone solutions are dictating price points, and the Cloud Connect is maybe focused on that, your current platforms may not be optimal to ship those are the prices that the Cloud customers are expecting. Is that a reasonable conclusion to look at the dynamic of very strong U.S. revenue, Cloud revenue, and very weak gross margins? And I imagine the ramping up of the Cloud Connect platform will help address that. Is that the major factor driving gross margins north in Q3?

Brian Protiva - ADVA Optical Networking - CEO

So, [Tim], there's clearly [we've] been addressing that in our last quarterly [comp] call, so you are correct.

We continue to see the currency fluctuation, it's not very gross margin sum, but you know that's [life] in our business, and the biggest one that's in our control is [the cross] platform, and yes we are shipping very high volumes to [Legacy]. So let's say, product into strategic customers and clearly our cloud connect will help that in a big way. So you are correct.

Tim Savageaux

Great, and one final question for me then, and thanks. And also, obviously, congratulations on the overall top line strength here. Are you to the point here where you can maybe count a single ICP customer as 10 % more of your revenue or is that increase that now the 25 % level more distributed over multiple customers?

Brian Protiva - ADVA Optical Networking - CEO

So we haven't gone live with that but we do have three customers in the 10 % type of range, or exceeding 10 %. But we haven't broken it out per segment.

Tim Savageaux

OK, got it, thank you very much.

Operator

The next question comes from Mr. Johannes Ries, please go ahead.

Johannes Ries

Yes, good afternoon, maybe follow one question on the cross margin topic - if cloud connect is coming the [big time] improves the gross margin and maybe even [results] for longer term or some will also maybe help to increase gross margins, therefore - is it feasible, or maybe can be expected to can return to old gross margins maybe in the higher digits? Or maybe a longer term means the next 2 or 3 years?

Stephan Rettenberger - ADVA Optical Networking - VP, Marketing and Investor Relations

That is clearly the goal, and Ensemble should be a big part of that, because it's software [with] gross margins.

Johannes Ries



So hold on, when will Ensemble maybe hopes to launch and how fast it could maybe start to grow, because you have given so large figures maybe you have someone comment from research institute about utilization topic, how big could be Ensemble, maybe could be a meaningful part of the revenues in some years?

Brian Protiva - ADVA Optical Networking - CEO

So, Uli, can I comment on the first question?

Uli Dopfer - ADVA Optical Networking

Yes, sir.

Brian Protiva - ADVA Optical Networking - CEO

And I think - no change to the way our business has evolved over the years. You move into 10 gig, then 40 gig, then 100 gig. And during the lifecycle of moving the new bandwidth moving from first movers to large volumes to massive volumes, margins do fluctuate throughout that. You're buying footprint, you're positioning yourself, you're building customers and then over time the margins do increase, you know, as you move through this stepping stone. Nothing has changed though, the one aspect to that is - is that things are moving a little bit more quickly, so the steps might be moving a little bit faster than the 10 to 40 transition back many years ago. But nonetheless we're going through those cycle and yes we will recover gross margins as you move - when you have established footprints, shipping latest technologies, you're driving better gross margins. So that's going to have the biggest impact, single biggest impact to our gross margin contribution over the next 2 to 3 years. But fundamentally ADVA's positioning itself as always using optical technologies and using Carrier Ethernet to drive different interesting application segments.

The transformation to NFV and the Ensemble software framework is strategic for us - point one, because our industry's changing at a volume. On point two, yes, we'll have a much higher margin contribution to us. But that's 2 to 3 to 4 year window of Ensemble really coming on board, building - supporting the transformation of the industry, because we're truly a leader here, we're supporting that transformation. But it will take a long time for us to drive volumes that really, you know, create impact. And that's the same thing with the cloud connect this year, you know, the bigger we get, the longer it takes for a new product and or product area to influence our gross margins. So I'd like to go about that a little bit differently, we will drive up our margins based on latest technologies, most efficient solutions, and there's a hundred gig layer and Ensemble longer term is strategic and will help us. But that's a long time coming before it really impacts our total company picture.

Johannes Ries

OK, very clear answer. But coming back to a very often asked question from my side you happen to be on a good way before you makes over to acquisition, and you - to my question, is it [past your hundred] if we are [capable] of about 500 million in revenues. We will come back to 10 % operating margin. I think after now, [as integration] of Overture and with cloud connect it is a good chance that we see in the foreseeable future the 10 %, is that a realistic assumption or target?

Uli Dopfer - ADVA Optical Networking

So it's clearly our goal is to increase our profitability to go into double digits, yes. As Brian has said it will take time, it will take money, many more investment [cycles] that we need to do and we need to continue to innovate. So, we're not bending our numbers for short-term, quick profitability. We consider - we have a long-term strategy going forward and we stick to that plan.

Johannes Ries

OK, but it's still [in rush EBITDA] or maybe targeted to be double digits?

Uli Dopfer - ADVA Optical Networking

Absolutely.

Johannes Ries

Finally, give me your product portfolio acquisition Overture acquisition, do you see a strong need to make maybe other acquisitions could be or then maybe for the timing could be lucrative your offering is now so complete that only small add-ons maybe are necessary to it moving forward?

Brian Protiva - ADVA Optical Networking - CEO

So, I'm going to answer that one Uli, and that is - we are from knowledge and information part of the equation - looking very good. We're investing aggressively, we're looking very good. We need to focus on our business. We've got a huge opportunity, we've got to conclude some of the new product introductions. We've got to optimize the business model, yes we've integrated Overture but it takes time and energy to do all of that work so that it's flowing as if it was all ADVA. So, I don't think there's anything out there short-term for us to do. But as I've indicated in the past, M&A is a very important strategic part of our business, and we will continue to look at M&A very closely, and if there's an opportunity to build size in an existing area, we'll take a look. But there's nothing pressing for us at this point, there's no need for us to respond to industry challenges ADVA's in a good [place].

Johannes Ries

Final point or remark from me, I believe maybe after you now maybe we'll definitely [pass this] 500 million this year. Next mid-term target could be the billion, isn't it.

Brian Protiva - ADVA Optical Networking - CEO

We'd love to see it.

Johannes Ries

Great answer, thanks.

Operator

The next question comes from Mr. Leo Bayer from Hauck & Aufhäuser, go ahead sir.

Leo Bayer

Good afternoon gentlemen, thanks for taking my question. Just a couple of more follow-up questions on specifications. I'd like to start with the cloud connect and maybe you can give us an idea what kind of percentage or how many devices in general you seek to replace, basically, with the cloud connect over the FSP 3000 in Q3 Q4 or in 2017 in general. Question comes from the side of that I would like gain an idea of how fast the ramp up can go. What's your target there? Also, if it might be too bullish, but general target what could be the replacement of the percentage, that will be the first question.

Uli Dopfer - ADVA Optical Networking

Brian, you want to take it, or should I.

Brian Protiva - ADVA Optical Networking - CEO

Go for it.

Uli Dopfer - ADVA Optical Networking

So as Brian said earlier, we are ramping up slowly as of now. Clearly the goal would be to do pretty much next year all of our DCI business, at least in the second half of the year with the cloud connect. We will see how that goes. Customers need to be able to go through this transformation as well. But clearly we will not replace



existing equipment that is out there, it will be just basically - new orders will be shipped then with the cloud connect and this will be a ramp up over several quarters. But clearly I said, in the second half we hope that the majority of our DCI business is driven by cloud connect.

Leo Bayer

OK, that's already helpful, maybe you can give us a further idea of basically, how far the majority of your DCI clients is evolved, like how fast could they now start implementing the cloud connect. So basically, what's the share of potential cloud connect customer who could start integrating the devices in their network, is that 50 %, or is that only 30 % - so how many are still in field trials or lab trials, and how many are ready to implement?

Brian Protiva - ADVA Optical Networking - CEO

So we don't break out that information publicly, but I would say over a 6 month period of time that we can - the cloud connect is so far superior to legacy technology, both from pricing but also from a feature richness. It's going to be a fairly quick transformation, my view, you know, so over the next - Uli says by the second half of next year the volume shipping will all be cloud connect, but it's probably a 6 month transformation where they start to qualify, certify and OK - release us for shipping the cloud connect. So I think it's going to be a fairly quick transformation from that aspect.

Leo Bayer

OK, but just to give us kind of a feeling and qualitative answer, is that the majority of clients that could go live with cloud connect already in Q3 and Q4, regardless of if they order or not, but basically have the majority of clients gone through the trial period already, or the qualification and certification process, or rather not?

Brian Protiva - ADVA Optical Networking - CEO

Let's say half of them and I would say not Q3, Q4 - I'd say in the Q16 months as I'd indicate you know in the Q1 most of them will have made those moves.

Leo Bayer

OK, great.

Brian Protiva - ADVA Optical Networking - CEO

The issue - and I think we've said it in the past is that the ICP community is very quick to react, very efficient in making decisions - new decisions on technology that match their needs. So a very quick moving customer base.

Leo Bayer

OK, cool. The last two follow-up questions - first one would be, coming back to cash flows, and Uli you mentioned in a side-note that part of the working - there was a decrease in working capital in Q2 actually, what seemed to grow a little bit, your operating cash flow. Maybe you could add some more clarification to that please?

Uli Dopfer - ADVA Optical Networking

Yes, absolutely. So as you know, two earnings calls ago I said we are not quite happy with the levels of our inventory. So we worked hard and with our supply chain teams to get out - decrease that inventory that we carry, and so, and you see the success simply because our inventory transferred up to 6.4, which is almost a record in our most recent history, so that is pretty success and this contributed of course to the high levels of cash flow.

Leo Bayer

And then just, maybe an add on - I'm just looking at one of the presentation versions that I have now, but there I continue to see that the days sales outstanding obviously exceed the days payable outstanding. Maybe you can give us kind of an idea when this is going to change again or do you have any - does it depends on any specific issues what you're experience right now?

Uli Dopfer - ADVA Optical Networking

There's no issue, actually it's just how customer payments fall and client payments fall. I mean we are clearly no company that plays dirty games with suppliers, so we - I guess we pay our invoices on time and we just how it [falls]. Currently we have an overweight of some suppliers who have payment terms in their advantage, and that's why you see a lower DPO right now than DSO. But I would say the good trend is that our DSO, despite having large customers and largely increased revenues our DSOs are improving as well.

Leo Bayer

OK, great, thank you very much.

Operator

The next question comes from Deutsche Bank, please introduce yourself.

Rob Sanders

Yes, hi, it's Rob Sanders here at Deutsche Bank, thanks for taking my question. I was just interested in just looking a bit further out over the next sort of 18 to 24 months. When you think about the top 10 ICP guys, I think you've got four at the moment that you're shipping to. If you just look at the other six, how many of those do you think you could win over the next, let's say, 18 to 24 months whether because of cloud connect or something else?

Uli Dopfer - ADVA Optical Networking

I think you should take this question, Brian.

Brian Protiva - ADVA Optical Networking - CEO

So I don't know how the connectivity is but I guess - but we haven't - you said 10 and then you said four. I mean, we have not gone live with any of that data so I think that's research then that is being done externally in the market there. But yes, we have a number of large strategic customers, and I think we are working on a number of new customers. Essentially, I mean we did win a new customer with the cloud connect platform for a very interesting application just recently and we do believe that we could win one, two, three, four more of the key large vendors out there.

But again, I think we need to be very careful. First of all, the customer base is very wary about having their names associated with any supplier. So, we're not going to go live and give that clarity. Lots of opportunity out there, we have a number of ways [of attack] that customers in different application spaces and wonderful differentiated solutions as well, some [me toos] and some differentiated solutions. So I think we can continue to win new accounts in top five or top ten segments.

Rob Sanders

Great. And one just a follow up. Would this be around currency, the euro sterling, I don't think [your head showed me] was that an impact you've got a large customer in the U.K. I was just was wondering if that had impacted your margin guidance in anyway into Q3? Thanks.

Uli Dopfer - ADVA Optical Networking

Yes, it definitely impacted the margin guidance the [SU took side] we have a large customer in the U.K. and the weak pound definitely put some pressure on our profitability but this is considered in our margin guidance.

Brian Protiva - *ADVA Optical Networking - CEO*

I'd like to say we have many customers in the U.K. and it's a very strong region. And yes, we [also] have one large customer but many customers, and clearly absolutely not a good situation for us. That clearly impacted our profitability in the second half of this year. And we hope things turn around and believe that things will stabilize again. But that was definitely a big hit to second half profitability numbers because, as you recall, we said we're going to make, we believe, nice gains into the second half. And we are making gains, but they would have been quite a bit higher had that not happened.

Rob Sanders

OK. Thank you, that's clear. Cheers.

[Operator Instructions]

Operator

There is a further question of Mr. Leo Bayer of Hauck & Aufhäuser. Please go ahead.

Leo Bayer

Thanks for taking - giving me a chance for the follow up. Just regarding Rob's question on the potential Brexit, and the impact on the sterling exchange rates. I think you mentioned earlier in the call it was 1-2 million euros and as an absolute figure and less profitability [excluded in the Q3 guidance], is that correct? Or how do we have to read the 1-2 million as you mentioned earlier?

Uli Dopfer - *ADVA Optical Networking*

It's probably in that range, yes. I mean, it always depends on how [set] our shipments fall and how recognition effects our budget could be mid-range. And of course, it depends on the how pound will develop.

Leo Bayer

Well, obviously. Yes. OK. Thank you.

Operator

There are currently no further questions.

Uli Dopfer - *ADVA Optical Networking*

Should we go back to Oliver Pucker's question earlier, Brian, when you dropped out of the call because we couldn't clearly - I mean, you were basically cut off right after you started to answer the call. Oliver, could you please repeat your question from earlier?

Operator Mr. Pucker, could you please raise a question?

Uli Dopfer - *ADVA Optical Networking*



He forgot his question possibly. Brian, do you still know the answer that you had? All right.

Brian Protiva - *ADVA Optical Networking - CEO*

So no, only I was noting it down, but I was looking through my notes which question. Sorry, I can't get us back there. I was panicked because I lost connectivity, we tried all different ways to get back into the call so I don't have that.

Uli Dopfer - *ADVA Optical Networking*

All right. [Then]

Brian Protiva - *ADVA Optical Networking - CEO*

So, I guess we need to wrap up. It's been an hour, thank everybody for their time and energy. Sorry that my connectivity was not that professional today, it was not planned, and back to normal procedures next time. And Stephan, thank you very much for supporting and helping, you were excellent.

Uli Dopfer - *ADVA Optical Networking*

Thank you everybody. Talk to you soon.

Brian Protiva - *ADVA Optical Networking - CEO*

Good bye everybody.

Operator

Thank you for your attendance. [Call] has been concluded. You may now disconnect.

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