an NTT Communications Company

Transcription

ADVA, July 20, 2017

Q2 2017 Earnings Call

Thursday, July 20, 2017

0:00 Operator
Ladies and gentlemen, welcome to the Q2 2017 IFRS Financial Results conference call of ADVA Optical Networking. This call is being recorded. After the presentation there will be an opportunity to ask questions. I now hand you over to Mr. Stephan Rettenberger, ADVA Optical Networking's Senior Vice President Marketing and Investor Relations. Please go ahead sir.

00: Stephan Rettenberger
Thank you and a warm welcome from my side. This earnings calls is a presentation which is available for download in PDF format from our homepage under www.advaoptical.com in the about us/investor relations section. Should you not have the presentation in front of you, you might 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 and anticipated demand for optical networking solutions, internal estimates and liquidity. These factors are discussed in greater detail in the risk report section of our annual report 2016. Please also be reminded that we provide consolidated pro forma financial results in this presentation solely as supplemental financial information to help the financial community make meaningful comparisons of our operating results from one financial period to another. This pro forma 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. As usual, Brian will start and provide a business update and outlook and then Uli will talk us through our Q2 2017 financials. And finally we will have sufficient time for your questions, which we will be happy to answer. Brian, please go ahead with the business update.

2:24 Brian Protiva
Thank you, Stephan, so moving as always to the business update and outlook, Q2 2017 in review: Revenues decreased by 8.3% versus the previous year to 144.2 million, this result is at the lower end of our guidance quarter. Our Q2 pro forma operating income was 9.2 million, or 6.4% revenues within guidance between our guidance framework of 5% to 8% revenues. We posted continued financial strength with cash and cash equivalents as well as net liquidity at Euro 80.8 million and Euro 30.8 million respectively. We experience solid demand from all customer groups, the Q2 increase from one of our major ICP customers, which we had seen in 2015 and 2016, did not happen. In addition we have seen strong demand for carrier infrastructure upgrades in Central Europe and we have won our first major carrier with our Ensemble software suite.

Moving on to page 5: So what do our prospects for Q3 2017 look like? Our results are strong but our forecast demonstrates a slowing of our business while we consolidate our margins and focus on introducing our new product architectures to market. Central Europe has been one region to show strength throughout the first half of 2017. The cloud will continue to drive demand for open connectivity solutions trading further expansion opportunities in DCI and metro core applications. In addition, we see strong RFP activity in the cloud access space, which will provide further opportunities for our expanded Ethernet access portfolio. From a product perspective we saw our FSP 3000 CloudConnect ramping in the first half but the growth projection seems to be slowing in Q3. Our Ensemble software architecture will continue to gain traction, albeit at a smaller pace than we had hoped, due to the operational process transformation which is needed to support NFV roll-outs. In addition our Oscilloquartz portfolio resonated well with many tier 1 accounts, giving us a solid basis for our return to growth mid-term. The acquisition of MRV will support growth at ADVA while our organic growth from the last years is consolidated.

Page 6, highlights: We announced the virtual or universal CPE win at Verizon on May 16. This win substantiates our large investment into NFV space while our Network OS, our hosting Edge OS allows our customers choice. With our software at the heart of their offering they can choose their hardware of liking and work with any number of the almost 50 certified VNFs or applications which we can host on our architecture. We are also open and extremely flexible when it comes to working within open standards and a proprietary orchestration layer. On June 18 we announced the upgrade of our metro core capabilities in order to support highly flexible and low-cost network builds, while introducing next gen open switching fabrics, supporting both OTN and packet capabilities. We also have integrated our sync and timing capabilities and knowledge to support TrueTime over the transport layer in order to meet the requirements of next gen networks, including 5 G infrastructure. And finally we announced the MRV acquisition. Going to the next slide for more details on this

Page 7, MRV summary. We have been in contact with MRV for over five years looking at potential M&A opportunities. After intensifying our relationship with MRV executive team over the last 18 months we mutually decided that it was important for ADVA looking for revenue growth and the expansion of our customer as well as for MRV, which needed greater resources to compete effectively, to combine our organizations in order an even stronger network equipment vendor. The main reason which helped us convince our board of directors to support this acquisition, was the expansion of our customer base with both North

American but also international accounts, including a number of strategic large accounts. Hence, MRV also diversifies our international revenues. In addition this acquisition further strengthens our position in the Carrier Ethernet market where we were already a global leader. The expanded number of EAD customers - that is Ethernet access device customers - as well as adding very interesting optical customer base, where we believe that we can add lots of value due to our breadth of solutions. And finally, we believe that this acquisition will be accretive as it has many synergy opportunities, such as not only the economy of scale but also a de-listing in the US, not having the need for two management teams and opportunities for efficiencies and quality operations, sales and engineering.

On to my final slide page 8, our markets and applications: The cloud is changing our market place rapidly and there are various models which enterprises are pursuing, including private clouds, hybrid clouds, and public clouds. The flexibility needed by these enterprises and their demands allow for differentiation and driving change with technology leadership. We are connecting the cloud with our WDM solutions, our CloudConnect. We are servicing cloud access applications by offering optical on-ramps, packet on-ramps and a family of security solutions securing the connectivity of the cloud. We are enabling cloud infrastructure players with our Ensemble Software Suite to use white boxes with a flexible choice of applications, security solutions our virtual connectivity. As an example our virtual connectivity capabilities allow our customers to extend layer 2 clouds over multiple data centers, data centers regardless of the type of network which are used to connect these sites. This allows greater flexibility when importing application amongst your data center infrastructure of choice. We also ensure your infrastructure, connectivity or packet layer networking through standards of integrated software solutions. In summary, we can support enterprises, ICPs or carriers with our solutions architecture. I would now like to pass the baton to Uli in order to cover our financials.

8:41 Uli Dopfer

Thank you Brian and hello everybody. Let us start with a few details about the bid that we submitted to acquire MRV Communications, Inc. I will then cover the financial highlights for Q2 2017 according to IFRS. As always, the pro forma numbers presented in these sections are calculated prior to non-cash charges related to stock-based compensation and amortization, an impairment of goodwill and acquisition related intangible assets. And unless stated otherwise, all numbers are presented in Euro.

Let’s move to slide 10, please, a few details on our plans to acquire MRV Communications. On July 2 we announced that we entered into a definitive agreement to acquire MRV Communications Inc. Earlier this week, on July 17, we made a tender offer of 10 US Dollars per share for all the outstanding common stock of MRV. This offer equates to an aggregate purchase price of approx. 69 million US Dollars. It has been approved and unanimously recommended by both the board of directors of ADVA Optical Networking and the Board of Directors of MRV Communications Inc. Purchase price will mainly be financed by proceeds of bank financing.

Let’s move to the next slide, to our Q2 numbers, IFRS quarterly revenue and pro forma profitability. As already stated, we ended Q2 2017 with revenues of 144.2 million Euros. This result is at the lower end of our revenue guidance of between 143 and 153 million Euros and represents a decrease of 8.3% year over year but a slight increase of 1.7% versus a strong Q1 2017. The decrease of 8.3% versus the previous year was mainly driven by the softness in the ICP sector which in turn supported an improved gross margin of 32.4%. Pro-forma at operating income in Q2 2017 was at 9.2 million Euros or 6.4% of revenues. This is in the middle of our guidance of between 5% and 8% of revenues and compares to 2.7% in the year ago quarter. Let’s move to the next slide, please.

IFRS profitability. In Q2 2017 IFRS operating income (**11:00**) was at 8.1 million or 5.6% of revenues, up from 3.1 million or 2.0% in Q2 2016 in line with the growth of the pro forma operating income. Our Q2 2017 net income was at 4.5 million Euros or 3.1% of revenues. This result was impacted by FX losses and a negative tax effect. As the number of weighted average shares outstanding has not changed significantly, diluted EPS developed in proportion with IFRS net income to 9 cents per share. Next slide please. Quarterly revenues per region: The 8% revenue decrease compared to Q2 2016 was mainly driven by weakness from lower orders, order volumes from a major ICP customer in North America. EMEA recorded stable revenues of 68.4 million Euros, representing 47% of our total revenues. In the Americas, Q2 2017 revenues were at 70.6 million Euros, representing 49% of total revenues which equals 11% decrease year over year. The portion of revenues in Asia Pacific remains low at 4% of total sales. Next slide, please.

Slide 14, IFRS consolidated balance sheet. Q2 cash balance was 80.8 million Euros, our net liquidity at 30.8 million Euros. Year over year, net liquidity increased more than 50% from 20 million in Q2 2016. Overall networking capital of 100 million decreased compared to the 112 million reported at the end of Q1, mainly driven by a decrease of accounts receivables. The number is also below the 103 million Euros reported at the end of Q2 2016. Trade accounts receivable decreased to 87.4 million which compares to 94.1 million at the end of Q1, DSOs increased slightly to 57.3 from 54.8 days. Inventories decreased further to 77.3 million resulting in an improved inventory turn rate of 4.9.; Trade accounts payables of 64.4 million remains on the same level as in previous quarters. Correspondingly DPOs also slightly decreased to 59.9 days. Stockholders' equity of 245 million is almost unchanged to 244.5 million reported at the end of the last quarter. We continue to maintain a strong equity ratio of above 50%.

Next slide, slide 15: IFRS consolidated cash flow. Cash flow from operating activities amounted to a strong 29.6 million Euros, up from 22.4 million Euros reported in the year ago quarter and up from the 4.5 million Euros reported in Q1 2017. Cash flow used for investing activities is more or less on the same levels as seen in Q2 2016 and Q1 2017, reflecting our on-going investment in future technologies. Cash flow from financing activities in Q2 2017 was at negative 4.2 million, mainly consisting of servicing existing loans. Free cash flow came in at 27.0 million versus 19.0 million reported in the year ago quarter. Now I would like to share our guidance for Q3 2017. Next slide please.

We are committed to improving visibility and predictability of our business, as in the past, we will continue to provide projections for the current quarter only. The numbers provided exclude contributions from potential acquisitions. 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. The long term growth prospects continue to be strong. As previously communicated there are both risks and opportunities around the visibility of ICP related business as well in realizing revenue, particularly in infrastructure business. Additionally we remain committed to a flexible cost and operating model that allows us to quickly adapt to changing market conditions and we continue to drive operational efficiencies within all facets of the organization. We consequently project Q3 2017 revenues of between 120 and 130 million Euros with pro forma operating income to range between 2% and 5% of revenues. 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 a review may result in non-cash impairment charges in Q3 2017 and beyond. The pro forma operating income guidance we have provided today excludes any such potential impairment charges. With that I would like to summarize today's call: Our Q2 results were solid, for Q3 we forecast a slowing of our revenues in particular in North America due to weaker demand from our leading ICP customer. Europe continues to show strength and the metro-core cycle in carrier infrastructure is healthy. We made an offer to acquire MRV Communications, the acquisition will enable us to expand our customer footprint, expand our market leadership in Ethernet access devices and expand our portfolio of packet optical solutions. We believe that this acquisition will be very accretive as it has many synergy opportunities. Thank you all for your participation in today's call and with that I would like to turn the call over to the operator to take your questions.

Q AND A SESSION

16:55 Oliver Pucker (Oddo Seydler)

Good afternoon, thank you. Maybe we can go to the questions one by one: My first question is for Brian, I think everyone was a little bit surprised by the relatively weak Q3 guidance, you explained the weaker Q3 topline guidance but maybe could you shed some further light on to why is the margin guidance also pretty low? In Q2 you showed a margin of 6.4% pro forma EBIT, so my understanding was that the ICP business was also very low margin business, so why now this decline in Q3 in the margin?

17:36 Brian Protiva

I think the combination, first of all, there are a number of things that flow into that, things like scale, so as you if we lose revenues we need to adapt some cost structures in order to drive higher margins. That is one issue, the second issue was our CloudConnect product. We had talked about margin expansion and we haven't been as successful as we would have liked. We reached double digit millions but a success that we liked with that product, so the transformation or the transition to next gen product, which has higher gross margins per 100 Gig connectivity, and those are the two main reasons. But as we then adapt and optimize our cost structures we can drive higher margins or higher pro forma EBIT to relative revenues.

18:27 Pucker

Okay, got it. And on the ICP business, so what was the ICP revenue share in Q2 and which revenue share is assumed in your Q3 guidance?

18:34 Protiva

So, the number over 20% in Q2 and 12, 13% in Q3.

18:44 Pucker

Okay, got it. And on the cloud connect, you already mentioned that it is a double digit figure, I mean can you give us a precise figure? And also maybe what do you expect for Q3 in terms of revenue?

19:00 Protiva
I think the precise figure is, we entered into the double digits and we said and Q3 so far does not look, as I said in my presentation that it is growing, but it could even be down slightly, depending on projects.

19:16 Pucker
Okay, got it. So is it fair to say that the demand for the CloudConnect is so far significantly below your expectations?

19:22 Protiva
Yes.

19:24 Pucker
Then maybe a question on the full year outlook, I think there was some confusion because in the six month report you published today you state that "… the company expects for 2017 only moderate revenue growth" and on the other hand in today's news release you state that only via the MRV acquisition you will be able to stabilize revenues close to last year's level, so which statement is correct and what can we expect for Q4?

19:56 Dopfer
I think both statements are somehow correct, I think we still can have a strong finish with our Q4, but is it very likely? It is going to be a stretch and the MRV acquisition will definitely help us to stabilize this number of maybe show some slight growth going into the end of the year.

20:14 Pucker
Okay, but without the MRV acquisition topline should be down year over year, most likely?

20:19 Protiva
Yes, it is very likely.

20:23 Pucker
And maybe one or two more questions – so on the tax rate. You showed the tax benefit in Q1, now significant tax expanse in Q2, so it still fair to assume a tax rate for the whole year in the low digits range?

20:42 Protiva
Yes, I would definitely assume this, we had this special effect in Q1 where we recognized certain things in the US, now we have, I would say, a normalized tax rate starting in Q2, on average I would still assume a tax rate that is it the mid to higher single digits.

21:00 Pucker
Okay, last question from my side. Free cash flow was pretty good in Q2, with more than 50 million, any indication for the whole year? Will this trend continue in H2?

21:12 Protiva
It depends on how are profits and how our margins develop, it is tough to say at this point but we had a very strong Q2, let's see how it develops, but I am optimistic that we continue to see a strong one, I don't know if we will be able to further increase with that rate but we are working hard on that.

21:36 Johannes Ries (Attus Capital)
Yes, good afternoon, definitely some follow-up questions to Oliver Pucker, maybe coming back to the ICP business: Maybe the problem is mainly one large customer and that is maybe also the reason why you are disappointed about the success of CloudConnect because to my understanding you always hoped that especially the ICPs will adapt this product. So is there any indication, is it only temporary weakness with this customer and the whole ICP segment – could we have some hope that maybe

in 2018 they Think and turn around or is it maybe it is a structural shift that the customer maybe moved away from you to another supplier, which is also rumored in the market?

22:20 Protiva

So, no, we are strategic supplier of our two ICP customers. One we have converted into a CloudConnect platform, we are working on it. We have numerous application opportunities that we will continue to pursue and we believe that we will enter both accounts and hopefully whenever large ICP opportunities, the CloudConnect is platform architecture, it is going to be very successful over time. It is our FSP 3000, so it has better software architecture, more scalability, state of the art interface capability, it has all the pieces. We made an announcement this year and the CloudConnect was a generation ahead of everybody else and their announcement ranges and those new products are coming beginning six months from now. So we feel very confident with the CloudConnect, it is a very competitive platform. But it is taking us longer than we had anticipated to get into some of our key customers but we do feel very confident that we will get in there. It is rather sooner or later and right now we are later on a couple and we have been sooner on a few others. So give us some time there, we are completely committed, the cloud connect is going to be a very successful product, we continue to invest a lot of time and energy in that platform and it is so much more effective than our existing architecture from scalability that is just naturally going to assume all of our customers over time.

23:55 Ries

Got it, maybe that could mean therefore it is more a timing topic and even this one large customer maybe most probably should come to the CloudConnect looking forward? And that means giving all the prospects, as mentioned in the ICP areas that 2018 most probably from today's view could be a better business year therefore, ICP business?

24:17 Protiva

From an ICP perspective, we need to execute well, but we have a lot less moving parts in the next round of product introductions, the software architecture has been stabilized since a year, hardware architecture all defined, so it is more about bringing out features rapidly in that new architecture. So we are positive, mid-term to long-term, clearly we have not performed as well as we would like to. Now moving to the 2nd half of this year, but it is not just the CloudConnect, we across the board - Carrier Ethernet product lines, we have never been more competitive – in the sync & timing architecture where we are one of a kind and winning almost every RFP that we enter. But it is taking longer to scale. Our Ensemble product – you saw us win Verizon, we are very competitive, so across the board we feel very comfortable with our new products which should allow us to win new foot prints and customers and grow our business. So we see this as a temporary challenge that we are pursuing to change that quickly, but clearly don't have all the controls in our hand. We have got to work with customer cycles, investments, market share at customers, if a customer has two or three suppliers, different times different suppliers get more of a spend, and that is just natural in our industry. So again, I feel comfortable with where we are at. Lots of work ahead of us.

25:48 Ries

Very clear, maybe coming back to Ensemble, you had this success with Verizon, maybe you can tell us about other prospects and how important Ensemble could be in 18 and 19, because those are the really the uptick years and also you could also on the margin side?

26:09 Protiva

So yes, I guess my view to the Ensemble to NFV space – and also in my presentation – is that the transformation needs by our customers to drive NFV at scale, it is slow. That is across the board globally, so selections are being made, first revenues are being generated, but probably the 2018 revenues that we would have thought six months ago are more like the beginning end of 2018, beginning of 2019, so we are in a number of tier 1, tier 1 RFP process, many tier 2 accounts came as working overtime, new releases coming rapidly and in general the price drop of the white box, the hardware that is needed for that flexibility and scalability is happening as we speak. That too though is a part of the equation, drive costs out as well as driving flexibility and scalability, the advantages of NFV. So again, transformational change takes longer than one thinks, always the NFV world is taking longer than anticipated, but there are all sorts of RFPs on the street and most carriers at this point are in a selection process. So that's all good, revenues should scale 2nd part of this year, scale more in 2018 but for the investments that we are making it is more like a really nice return into 2019.

27:38 Ries

I got it very clear. Maybe on the old margin topic – the gross margin has improved but it is still far away from former maybe cross margin levels you achieved in the 40s. The target is clear to improve the gross margin further by the software and even by CloudConnect, if I got it maybe the next two years if you succeed with your new products, especially CloudConnect and Ensemble, there is a change to clearly improve the gross margin and then make a bigger step in the operating margin to your long term target of 10%? Is that right?

28:10 Protiva
For sure. I think also the combination, consolidation of our industry will help that as well, so the combination of new product, driving innovation and getting more contribution from some of the areas outside of our optical strength and just general consolidation in industry will drive higher margins.

28:33 Ries
Two other questions maybe, first the IoT. If you look to charts by guys like applied material, an equipment company, which shows a tremendous increase of the amount of data which coming from IoT e.g. by automatic driving, that would also maybe drive the data center part and maybe would lead to a much more decentralized data centers because the power consumption of the large ones is maybe not handled by the utilities anymore and that would mean more connection and therefore more business for you? Therefore even if you see the big picture it also could support your growth going forward, is that right?

29:17 Protiva
In general our industry is growing, we are not walking away from the 8% over a longer period of time. Remember, we grew a 30% in 2015, close to that in 2016. This year is more of a struggle but if you look at our last five years we have outgrown the market. And we believe that we can do that over the next five years again, so there is no question. And IoT is nice but to tell you the truth there are other areas, the video augmented reality, virtual reality, those things are just all video driven, that is massive bandwidth. Transformation of the cloud, people ripping out their data centers down in their basements and putting them up there in the cloud, massive bandwidth. I don’t think we need to worry about bandwidth grow, it is here to stay for the next ten years, and that is what has always been our challenge too many suppliers out there, and again it is consolidating, slower than we like but it is consolidating, year by year and that is going to help, the bandwidth growth is let’s say 30%, and only 8% market growth, WDM reaching a 14 billion dollar industry, it will be 20 billion one day. It will be 20 billion much faster with fewer competitors.

30:36 Ries
And you will definitely be one of them.

30:41 Protiva
We have made it over 20 years, and with much less resources so I feel that we are capable of making the last steps.

30:48 Ries
Okay, really the last question I forgot it, more technical, MRV – how fast do you think you can turn it around, could it be next year or is it too early to reach a break even or even a positive result?

31:00 Protiva
So we are saying accretive, rapidly.

31:06 Tim Savageaux (Northland Capital Market)
Hello there. A couple questions, first with regards to the guidance, maybe the results and guidance. A couple of moving parts there but you are pretty clear about the extent of the revenue decline you expect on the ICP side which really I think takes it back to levels prior to any material traction with some of the bigger guys or around those levels but that still doesn’t really account for all of the sequential decline you are guiding to, more than half of it, but certainly not all of it. So my first question would be: What else are you seeing in terms of softness of a sequential basis, whether that is seasonality in Europe or what have you that might be accounting for the balance of that decline, and I will move on from there.

32:11 Protiva

So I am not sure about the numbers that you are referring to, maybe on an annual level percentage wise you might be right, but if you look at Q3 to Q3 you will see that probably, or most definitely more than the decline could be declining from ICP purchasing.

32:31 Savageaux

I am looking sequentially, Q2 to Q3, and maybe I misheard you in terms of the response you gave to cloud percent of revenue, I thought you said it was 20% in Q2 going to 12 to 13 in Q3, so that ….

32:50 Protiva

(interrupts) We can go through that, I thought you meant annually. From an annual perspective it is ICP declining, the rest of the business pretty much growing, but slightly. From a Q2 perspective you are looking at, depending on where we are in our guidance range, it could be just that piece, if we were at the lower end, why would we be at the lower end and that would be slowing in the summer months of Europe. And further slowing in some of our accounts in North America, but that is the range. And it really depends, so in the models you can see a little bit of slowing in North America, summer months in Europe. And that would be the formula, but again compared to last year Q3 perspective I think we are good to go on the other business.

33:42 Dopfer

Tim, maybe there is a big portion of enterprise business as well, and as you know it is always an issue of can you recognize revenues in these larger enterprise projects. So this could also be a factor.

33:55 Savageaux

Right, but you are not really saying anything about demand necessarily in these other segments but just more this normal variability and how things come in in terms of carrier metro, enterprise – so cloud is the key driver. Understood. It looks as if in your Q2 results you did have some declines on the operating expense side. And I don't know if that was anticipating anything or what have you, it seems like if we look forward you are expecting – and this is pre any MRV discussion, I will come to that in a moment – expect to kind of maintain around those levels. I assume – A, if there is any drivers for the opex, modest but incremental opex declines in Q2, and then I assume that as we look to Q3 with the sharp decline on the cloud side we will see results in boosts in gross margins; that is probably the prime driver of your maintaining profitability in that 2% to 5% range.

34:57 Dopfer

So the opex is slightly down, this is correct but this is nothing special, it is like FX rate, you know the US Dollar has gotten much weaker than in Q1 and a few pieces here and there but nothing out of the ordinary.

35:15 Protiva

And as far as going forward, I think what we said and we have committed to manage our costs effectively. We are investing like crazy, we have 1800 people, have well over 800 engineers. We are investing like crazy and have opportunity for managing operational costs going forward to adapt to an environment. We cannot do it overnight, the other way is that we would smooth roll it, protecting our people but at the same time meeting support of shareholders, so it is something then that we would be committed to make sure that we build a model that makes us successful in an environment if revenues are lower for some period of time. And we have gone through this before, over 20 years I have had three of these experiences, maybe four of these experiences. It goes for a period of time and then we come back out stronger, so I don't think there is any difference here and we will manage our costs accordingly.

36:10 Savageaux

Right, and I am just going to assume that – these comments on the gross margin question, I guess, my assumption is that from a mixed standpoint that will be moving higher.

36:19 Protiva

So I go back to what I said, I think you know when revenue kind of does decline you do have an issue there with gross margins because you have fixed costs, manufacturing, operations issues there that you need to adapt and you cannot adapt right away. The second piece is the CloudConnect is not ramping as fast as we had hoped or anticipated, something that we are looking at very closely and we are going to turn that boat around and make sure that it is very successful, long term commitment there, that will help. So as that gets rolled out, clearly that will help our margins. And in Q3 as indicated, CloudConnect doesn't look like it is growing quickly and that is maybe part of the reason that when you look at it from a margin perspective those two pieces declining revenues and the cloud connect ramping fast enough, doesn't give us a real bump, like maybe someone would expect, as we do less ICP business but I think we will turn those ships pretty quickly.

37:18 Savageaux

Got it. So more as much cost control heading into Q3 as anything else.

37:26 Protiva

Absolutely, cost control and continue to focus on ramping new product architectures.

37:31 Savageaux

And I know this was addressed before, but I expect ex MRV you would expect a flattish profile in Q4 or at best some recovery seasonally in the organics business, and the commentary MRV doing around 20 million dollars at least a quarter is what gets you back towards your X2 type run rate, at least that is the way I am interpreting it. Your comments, and I guess what I really wanted to ask you to do is possibly put some more quantification around the synergy potential – I had sort of speculated, given that I cover both companies – that there is a lot of synergy potential, as you say. I had talked about the potential for if we look at your operating income run rate, even in Q2, kind of 9 million dollars or so – something that is as much as 25% or 33% accretive to that number, just from pretty reasonable opex synergies over MRV. I wonder if you would like to endorse that number right now?

38:41 Protiva

So, first point, I think, is we haven't closed the deal. We have seen through due diligence a lot but we don't have our hands around every 100% transparency. We were partly competitors and therefore that was a very delicate balancing act. So I think we have a good understanding but there is not enough, not 100% security to make statements like that. Number 1. Number 2, I think the right time for that is after closing within a short period of time we will then inform what our plans are, clearly on that. From revenue perspective, and this is just now high level, nothing specific, yes, our goal will be to at least maintain, we are going to try and drive synergies on the revenue top line as well. That is often difficult and takes longer because it is taking their customers that we are going to support like hell, also on their existing product architectures and hopefully move in some of our products and opportunities into them. So that is one aspect, and I think we have some highly differentiated products. Once you have a contract in place, like we can all walk in and talk to them about it, Sync & Timing, ALM, about some certain carrier Ethernet additional products that we have, so there is complementary there as well. But in general if we manage the ball what we are committing to is accretive, we have never made that commitment in the past when we did an acquisition. We have always said it is about a technology play, in addition yes, to winning customers. In this case we believe it is all about the customers. We need to make sure that our customers are highly motivated to stay and work with ADVA and that all the decisions are going to be wrapped around that. But we see from what we see, from a combined operational cost platform ADVA plus MRV, there are a number of synergies. We have mentioned two of them, delisting, mentioned another one, we don't need two management teams. But there is a whole lot of opportunities that we have talked about as well, so assuming something right now, I think you can assume a number, cannot substantiate it, but I think it is going to do nice for our P&L development for the next 6, 9, 12 months.

40:46 Savageaux

Understood. And final question from me: Any impact either in the quarter or in the outlook from any supplier product quality issues?

40:53 Protiva

I think we have done well to manage – we have had quality issues, time in and time out over quarter for quarter. Sometimes people publically announce their quality issues, I don't think at ADVA we have been confronted with a problem that massively impacts us, but always clearly we are looking at managing that very well. I think we have everything under control, work very closely with our suppliers. I think that we are in good shape to manage the challenges we have at customers in our quality. We have very good quality metrics as a company. It is something we pride ourselves on. So from that perspective all good from an ADVA side of things.

41:38 Savageaux

Thank you all, will pass it on.

41:44 Sascha Seiler (K&R)

Hi there, thank you. You know, as an investor from an outside perspective, and you touched upon that in the last question a bit, it is not directly visible why MRV is such a great deal for you, because the company has apparently struggled in the past, they never turned a profit in the last couple of years, has seen a topline shrink, so apparently was also not too competitive. So as an investor it is a bit difficult to see why that is a good deal in terms of capital allocation. And maybe you can explain a bit – you mentioned cross selling opportunities but maybe you can explain a bit, what went wrong with MRV in the past? So to understand why this company has struggled so badly and what you can do about it? And the second question is simply on financing: I am curious why you did not use the cash here on the balance sheet to finance at least parts of the deal, why you would rather take on debt to do that?

42:43 Protiva

Well, I think – MRV we had a couple of slides on that, so I will repeat why it is good: One is customers, so strategic customers. Tier 1 accounts and accounts we think we can build the opportunity, because ADVA is a much bigger and more solid company, sometimes MRV was not getting the chance or the market share of their position at existing customers already. So that is one very important piece on the customer side. Second piece is: We are the global leader in Carrier Ethernet. So you can imagine they have very good Carrier Ethernet business and some very strategic customers. We from day 1 – there are a lot of synergies – synergies on cost, supplier costs, ability to manufacture those products less expensively, leverage of the features that they have or the features that we have into our common, mutual architectures. And then the ability to drive greater revenues in an area where we are already the global leader. Those are all areas that we can drive upside very nicely. From a perspective of they struggle, they weren't big enough, also in the presentation, they weren't big enough. You have a few million dollars cost just to be a public company, you've got millions of dollars going into a management team that was expensive as ours. So you are looking real chunks of opportunities and the keys will be leveraging their great relationships and their sales organization to drive value for ADVA even beyond the MRV issue. Leveraging their engineering teams to drive even further feature richness as the global leader in this space, we are going to win ever more deals. So I think there are a number of reasons why a small company that doesn't have leverage cannot get the scale needed to run a successful P&L. And that changes ADVA. And yes we are going to have to make some hard decisions and make some synergy decisions and optimize the organizations but we are very capable of doing that, we know the business intimately, we know the products intimately, we know the customers. You have all the services organization set-up, etc. etc. etc. So you can imagine that there is huge leverage from an acquisition like this. Synergies, and it is why I say there will be more M&A within our industry, because I have looked at everything and I see a tremendous amount of synergies when you look at businesses overlapping in the same segment. Now, you have to be very professional, you have to have the processes and you have to have the right IT infrastructure, and the right management team, communicate, communicate, communicate. But there are huge opportunities in the synergies which I believe will also help us drive a much bigger concept of our industry consolidation which will help average gross margins in our industry, also over the next two, three, four, five years. So I like M&A. I think this is one of the opportunities out there and I think there are lots of good things that will come out of it.

45:57 Robin Brass (H&A)

Hello everybody, and also thank you for taking my question. I guess most of my questions have already been asked but maybe two more. One is again the major ICP: do you have any indication why those orders didn't come? Is it maybe a technical preference from another supplier, or is it maybe a better sales pitch from another supplier or what is the case here?

46:12 Protiva

You know, the large customers have multiple suppliers. And you go through ups and downs, market shares and everything else, time to market, pricing, relationships, answers and RFPs that were important for a customer, it is a complex environment. And you need to get everything right to make sure that your market share at that customer is highest that it can be. So you are not always in the situation where you are getting all the market share you got last year or two years ago or three years ago, that is just natural. Now we had a lot of exposure to one of our large ICPs but we feel comfortable with the relationship, ADVA is a good supplier, we are doing business, we are not getting as much market share essentially as we should be right now. That was our failure as an organization but we feel very comfortable with our position and that we can come back and have opportunities to win. So in general, again, I don't think we executed as well as we could have. I think some of you also know that we were a little bit late in getting the product to market due to some of our brand-new architecture due to some suppliers' execution, due to also issues, the needs of a certain customer at a certain time. So it is very complex environment but I think we are managing our positions very well and it is only a matter of time before we get bigger market share at any existing customer. Having said that we might lose the market share with some other customer next year and in this case it was our biggest customer and therefore we see from a revenue perspective, but you see us declining but still decent – we are not burning a bunch of cash, yes we now have a lull, natural and our revenues are going down and we need to manage quickly, adapt our costs, position again and get ready for the next growth phase.

48:20 Brass

Also one follow up on cloud, when you introduced the product last year I guess you had a competitive advantage here in the environment especially with the 400 Gig speed. But I have seen that one of your main competitors also introduced now some sort of dual 200 Gigabit and also had 400 Gig speed. So did you maybe lose a bit this window of opportunity, were there delays overall?

48:39 Protiva

So yes, I think that if you look at – there are a number of competitors that have similar solutions, it is an arms race. Today it is 200 Gig, it is 16 QAM technologies, kind of state of the art. The client side is 100 Gig, so many of the competitors have a concept that is similar. And it ranges anywhere from – when are you having 400 Gig of bit capacity to 1.6 Terabit. If you look at the next generation that has been announced out there, and you look at ours, we are 3.6 Terabit in that 1 RU – compared to some of our competitors at 2.4 or even 1.2. So we feel that we can compete, we just need to make sure that we are time to market at the right time and working with the partners. We believe that we have the right partners that are technology leaders to help us differentiate our products. As an example, and then you have some really cool things that we worked on, things like our MicroMux which is expanding the 100 Gig ports for 10 and 40 etc., making our product very flexible. Also we were late on that program and project, I think it is an excellent solution, it is going to start having an impact in the second half of this year but time to market, there are other differentiators that we have out there. So there is the big feeds – you know, speeds and feeds – right now we are all somewhat equivalent, we believe that in the next that we are quite a bit ahead, let's hope that stays that way. And we have other differentiating features out there that we feel that we can use in order to continue to establish ourselves at our strategic customers and hopefully use to win new foot prints.

50:30 Robert Sanders (Deutsche Bank)

Yes, good afternoon. Sorry to belabor the ICP question but if you look at the sales cycle, when is the next opportunity to win this customer?

50:43 Protiva

So, these types of customers have different applications. And it really depends on these customers, they do everything from buying plugs to building their own architectures, to sourcing transponders to sourcing complete end to end optical solutions to sourcing optical line systems. These are highly capable, very technical, very transparent to our industry, because they have hired a lot of our people, so excellent companies with strong visions investing aggressively. Understanding so that there is not just one-offs. So certain areas they spend more money than in other areas, naturally if you are looking at the 100 Gig or one day the 400 Gig clients transporting over a 200, 400, 600 Gig wavelength, that is most likely their biggest spend. Transponders, but they spent a lot on the optical plugs as well, a huge amount in the optical plugs. So there are different opportunities in these accounts to win business, now, the lion share of the business might be in a certain type of a transponder for short haul applications, let's say. Or metro applications and therefore it is not a simple answer. It is a complex answer and clearly we as an equipment provider and our competition want to get the big piece of the spend. And that is the competitive environment, we will see when do we get a bigger market share at our key customer base? That is going to be interesting, and it is all about execution and time to market and partnering with the right people, etc.

52:30 Sanders

Got it. So we can just look at this one customer: When would you say is a realistic target for that company to become a 10% customer again?

52:38 Protiva

I would say it is next year, I would say it is not something that happens in the next one, two, three quarters

52:45 Sanders

Got it. And when you look at the pricing environment right now, it seems pretty brutal as an outsider but what is it that you are seeing on the inside, particularly these cloud guys where it seems like a lot of people are sacrificing margin just to win a beachhead for these big guys. Have you seen anything deteriorate in the last year, maybe post the China issues of Q1?

53:10 Protiva

You know for the people who follow ADVA, a year and a half or two years ago I said I don't even want more than 10% of our business to go to ICPs, because of how good they are in understanding constructing and doing and designing their own products and all those other pieces, so it was a balance. And then our business grew a lot faster than that which was definitely good for us but the fact is when you look at the business as a whole, it is strategically important for us, margins aren't going to be high ever in those areas, they never were. So it is not something that is changing, it is something that they are not high and in general at carriers as well, margins aren't particularly high because they have tremendous choice still. They don't have two people that they can go to – they have eight people. It used to be that they could go to 32. Now they can go to 8 people or 9 people. That is going to consolidate down to 5 and 6 and 3 and 4. Looking at the margins of the IP packet layer where there is really four providers, they are still in the 60s gross margins. Our industry is in the 40s, gross margins but hopefully it comes down to 8, to 6 down to 5 and it is going to go into the 50s gross margins over the foreseeable future. So it is arms race, it was always a brutal pricing environment and by the way, when companies are really challenged and we have a couple out there in our industry today, that is when the pricing gets sometimes a little whacky for some period of time. But when a company is really challenged they can only hold that up for a certain period of time, they cannot do business at zero margin. So you might get some crazy pricing out there but that has been the way for 20 years. We have phases of more competition, phases of less competition, depending on the regions and the competitor. It is a moving, fluid environment and my senses are that the industry is now in a low 40s - high 30s low 40s - gross margin environment, and it will be moving up. It is taking a bit longer than I had anticipated but it is going to happen. And the ICP face because of the volumes that they buy and the ability for them how they drive their networks, very simple networks, they will have much better pricing than other segments.

55:33 Sanders

Got it. And you know typically what happens in these industries is that if you guys are not making money then the suppliers get squeezed so why would you not look to triple source your suppliers of the DSP, e.g. just to get some significant costs down in order to stay profitable and to stay in the game?

55:55 Protiva

So I think in general, staying in the game – we are profitable, we generate cash, we have a good balance sheet, we have multiple legs to stand on, many different types of customers, I think it is fine. Yes, very competitive environment. So how do we drive a better model because you as a shareholder want to hear and see 10% plus profitability? And we have to look at that. And so, yes, multiple sourcing of products is absolutely part of our strategy and we will continue to go down that pipeline. I do have to say, we have very good relationships with strategic partners and it is a combination of technology leadership and pricing. And we have to manage those pieces and manage them together, so it is just not simple here – sources from 5 people, it is all the same and we just go and hammer them down in pricing to strategically we want to differentiate our products and we partner with people and yes, drive down pricing, which we need to do. And yes there is opportunity for multiple suppliers in every segment that we have today, there is no segment where we have to be single sourced, that is clear.

57:00 Sanders

Got it, my last question would just be on MRV – I think that they have disclosed that (inaudible 57.04) are big customers for them. Can you just think where they are positioned there and what would be your strategy? Is it to really ramp down what MRV is doing or is it just a cross sale play? If you just pick on those two customers, because they seem quite flagship, what your strategy be assuming this deal closes?

57:23 Protiva

So I really want to go down, let's address that next time around and we can discuss together. Again, we have not closed the deal, I don't want to step on their turf in any way or form but to tell you the truth I have given indications, customer is king. You will see ADVA jump through hoops for those customers. But we have tremendous leverage, we have got great quality, great operations, logistics, management, IT, processes, buying power, other products to sell – we have so many pieces to go drive synergies. So I don't want to talk any more about who their customer is, I don't know what they have made public or not at this point and we will address it when closed and integrated.

58:07 Protiva

I think we are well over time actually, it is three minutes over time – are there other questions out there or is there one last question or can we wrap it up? So last question.

58:22 Tim Savageaux

Thanks Brian. And it should be, at least it is a quick question, I don't know about the answer. But it really was on the competitive front. You've gone pretty directly through kinds of speeds and feeds and other comparisons for data center interconnect. But I wonder if you feel like some of your competitors' ability to offer a broader range of products to the ICPs in particular, as they build say subsea networks, for example, long haul networks, or other areas of the IP networking, in any way kind of effects or disadvantages you from a competitive standpoint, in addition to any head to head DCI capabilities? As you look forward, is there any opportunity or advantage of you having a broader product line into some of those areas or do you think the competition is very much straight on the DCI capabilities?

59:29 Protiva

So first of all the needs of the ICPs are different than the carriers, so people need to make sure that they can address those needs. Second, all of these ICP players have multiple suppliers. Then yes, there will be leads and certain markets and application segments just like there is in tier 1s. So I don't see that necessarily being detrimental. Now if one of these ICPs says I am going one single source supplier and I have lots of subsea business, clearly that would be a disadvantage, but we are not in the subsea business. But I don't see that anywhere. Not in any account and I haven't seen it being a disadvantage in any form, I think the key is to trust quality supply, support, great technology on great price performance, those are the keys to winning those businesses, or keeping those businesses.

With that thank you for all the questions and we are working hard to drive revenue growth into the future. Sorry to be the bearer of bad news today from a forecast. And I look forward to talking to you at our next quarterly financial analyst call.