an NTT Communications Company

Transcription
ADVA, October 26, 2017
Q3 2017 Earnings Call

Thursday, October 26, 2017

00:00 Operator

Welcome to the Q3 2017 IFRS financial result 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 over to Mr. Stephan Rettenberger, ADVA Optical Networking Senior Vice President Marketing and Investor Relations, please go ahead sir.

00:31 Stephan Rettenberger

Thank you, and a warm welcome from my side. This earnings call builds on a presentation which is available for download in PDF format from our homepage, 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 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 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 substitute for historical information presentation in accordance with IFRS. Pro forma operating income or loss is calculated prior to non-cash charges related to the stock compensation programs and amortization and impairment of goodwill and acquisition related intangible assets. Additionally, from Q3 2017 onwards, non-recurring expenses related to the restructuring measures are not included. Unless stated otherwise, all numbers are presented in Euro. We will target to limit this con call to 60 minutes and as usual, Brian will start and provide a business update and outlook, then Uli will talk us through our Q3 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.

02:38 Brian Protiva

Thank you, Stephan. So I would like everybody to move to page 4, Q3 2017 in review. Q3 revenues came in at 111.2 million, down sequentially from 144.2 million in Q2. And down annually from 159.5 million in Q3, 2016. Our revenues were still within our adjusted guidance, provided in late August, between 110 and 125 million. This revenue figure included a portion of the MRV quarterly revenues which were realized post our August closing in Q2 around 6 million, sorry post our August closing in Q3 around 6 million, Q3 pro forma operating income fell to € -0.8 million or -0.7% of revenues, and also within the revised guidance between -4 and 2% of revenues. Our post acquisition one-time restructuring costs hit € 8.4 million. Our Q3 revenue drop was coupled with a further guidance reduction within the quarter, as already communicated; this was driven by very low demand from one of our major ICP customers and an ordering ramp-down from one large carrier customer going through an M-and-A transaction. On a positive note the carrier enterprise business in Europe continues to build some momentum and we are strategically well-positioned to benefit from this opportunity. Prospects for Q4 2017 page 5: North America revenues have stabilized at a lower level. This level should not change until uncertainty around one of our large carrier customers is cleared, based on their purchasing volume decline due to them being acquired and the continued slow-down in ICP market space, which has been experienced by a number of equipment vendors reverses. ADVA's profile is sharpening as the European innovator with growth in Europe and outstanding new products, such as our Sync and Timing solutions, our NFVI Software platform and our latest products in the optical and carrier Ethernet spaces we are now selling to all the major tier 1 carriers in Europe and into most of the tier 1 carriers in the US. But we have lots of work ahead to build these customers by increasing the number of application spaces we address within their networks and their capex spending. We feel that we can cross-sell into our existing customer base effectively. Moving to the third bullet, we have seen from the many announcements as of late that the markets are stable but not showing much growth. We see results from other innovators in the communications sector, such as Juniper and Ciena. It seems that the increase in bandwidth demand has largely been offset by the speed of innovation and the price erosion due to global competition. Bottom line is that not enough consolidation has occurred in our industry over the last 12 months; besides of course our MRV acquisition. This will change as a competitive landscape will force more M-and-A activity over the coming year. And finally the MRV integration and consolidation is progressing according to plan. We have expanded our product portfolio, we have updated our road maps, we have refocused our sales and engineering teams by aligning them to our customer commitments. We have already successfully driven cross-selling upside to existing MRV customers by selling them encryption solutions from ADVA, and we have removed close to 20 million of annualized costs for our 2018 fiscal year. We still have further work ahead to remove operational cost for 2019. This progress gives us a solid basis for profitability and cash generation into 2018 and beyond.

Page 6, our strengthened executive team: We would like to formally introduce Scott St. John as an executive officer and a new Vorstand member of ADVA Optimal Networking SE. He will be responsible for our sales and marketing departments. Scott's prior experience comes out of the Telco landscape and he has led MRV sales and service organization for more than three years. He is structured, strategic, and understands our industry intimately. He also has customer relationships which will help us expand our sales focus and drive growth with our highly competitive product portfolio. And finally he is a natural fit for ADVA as he will immediately be able to leverage our global sales teams to cross-sell into both existing ADVA and MRV customers. Our new team is highly aligned and we will quickly be able to focus on a number of bigger opportunities to drive both margin expansion and growth. And in my final slide page 7, serving the cloud: As I have mentioned multiple times, the cloud is changing our market place rapidly. This is creating a large opportunity for the companies with technology-leading innovative solutions. Looking at the slide under bullet 1, we are enabling enterprises to have secure on-ramps to the cloud, under bullet two we are focused on building best in breed solutions for interconnecting data centers in order to enable global clouds or distributed infrastructure and under bullet 3 we have found a new and interesting application in which we allow for the cloud titans to globally synchronize databases, file directories, support blockchain applications and offer synchronization as a service to their customers, such as the financial and utilities verticals. We are now serving the cloud customer base with our complete product portfolio. So how are we winning these opportunities and with which products? In the cloud access space we are servicing cloud access applications by offering FSP 3000 Optical Onramps, our FSP 150 Carrier-Ethernet solutions and a family of security solutions securing the connectivity to the cloud. The MRV solutions expand our capability with 100 Gig NID products and a much broader aggregation capability. We are also enabling cloud infrastructure access players with our Ensemble Software Suite, allowing them to offer any application, including not only security solutions but also SD-WAN firewalls, Deep Packet Inspection, and many other applications on standard hardware. In summary, we offer virtual or highly flexible cloud connectivity solutions with the ability to offer any required feature or application on a common hardware infrastructure or a simple white box with an Intel processor. In the DCI connectivity space we are interconnecting the cloud with our WDM solutions and our FSP 3000 CloudConnect interconnecting the cloud. And finally in the synchronization opportunity we are selling network-based timing and synchronization solutions such as our 54XX family and Cesium clocks in order to upgrade data centers so that they can have network based timing available. Bottom line is that our customer segments, our telcos, enterprises and ICPs need our solutions, in fact our complete set of solutions. The cloud opportunity continues to grow. And with this I hand over to Uli to go through the financial section. Thank you very much.

09:38 Uli Dopfer

Thank you, Brian and hello, everybody. I need to admit that I have a bit of a cold and if my voice really gets bad or I have to sneeze too much, I may have to defer to Stephan but let's try. So let's move on to slide no. 9.

IFRS quarterly revenue and pro forma profitability: As already stated, we ended Q3 2017 with revenues of 111.2 million euros. The result is within our updated revenue guidance range of between 110 and 125 million euros and represents a decrease of 30% year over year, and of 23% compared to Q2 2017. The decrease versus the previous year was as mentioned by Brian mainly driven by lower demand from our largest ICP customer, as well as one significant carrier customer going through a merger. On a positive note the change in customer and product mix combined with successful cost reduction efforts led to a much healthier gross margin of 35.2%. Pro forma operating income in Q3 2017 was at -0.8 million or -0.7% of revenues, this is in the middle of our update in guidance of between -4 and +2 % of revenues and compares to 5.2% in the year ago quarter. Let's move on to the next slide please.

IFRS profitability. In Q3 2017 IFRS operating income was at -11.5 million or -10.3% of revenues, down from 7.2 million or 4.5% in Q3 2016. This result was impacted by 8.4 million euro restructuring expenses, including headcount reduction, site closures and impairment of capitalized R&D projects, leading to cost savings in 2018 and beyond of about 20 million euros on a run rate basis. Our Q3 2017 net income was at -40 million euros or -12.6%. As the number of weighted average shares outstanding has not changed significantly, diluted EPS developed in proportion with IFRS net income to -28 cents per share. Next slide.

Quarterly revenues per region: Due to the aforementioned reasons, the Americas Region is down by 55% year over year, and now represents 39% of total revenues. EMEA recorded revenues of 60 million euros, representing 54% of our total revenues and a healthy growth of 15% year over year. The portion of revenues in ASEA Pacific remains low at 7% of sales.

Slide 12. IFRS consolidated balance sheet: Q3 cash balance was at 57.2 million euros, our net liquidity at -44.1 million. Year over year net liquidity decreased mainly due to the cash based acquisition of MRV communications in Q3 2017. Overall, networking capital of 136 million increased compared to the 100 million reported at the end of Q2, mainly driven by a decrease of accounts payable. Trade accounts receivable decreased to 84.9 million which compares to 87.4 million at the end of Q2. DSOs however, increased to 71.3 from 57.3 days. Inventories increased to 90.7 million resulting in an inventory turn rate of 3.7. Trade accounts payable decreased to 39.3 million compared to the previous quarter, correspondingly DPO also decreased to 61.2 days. Stockholders' equity of 228.6 million is down from 245 million reported at the end of last quarter. Still we continue to maintain a strong equity ratio of 46%.

Slide 13: . Cash flow statement: Cash flow from operating activities amounted to -25.9 million euros, down from the 15.7 million euros reported in the year ago quarter and down from 29.6 million euros reported at the end of Q2 2017. Cash flow used for investing activities is at -48.9 million, caused by the cash outflow for the acquisition of MRV communications. Cash flow from financing activities in Q3 2017 was a positive 51 million, mainly consisting of a new loan for the acquisition. Free cash flow came in at -29 million versus positive 11.8 million reported in the year ago quarter.

Now I would like to share our guidance for Q4, 2017. Slide 14. We are committed to improving the visibility and predictability of our business. As in the past we will continue to provide protections for the current quarter only. As previously communicated, there are both risks and opportunities around the visibility of large scale projects as well as recognition of revenues, 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. Consequently we project Q4 2017 revenues of between 115 and 130 million euros with a pro forma operating income range between 0% and 5% of revenues. Additionally 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 projects such may result in non-cash impairment charges in Q4 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: The results we announced today were not the results we hoped to achieve for Q3 2017. The drop in revenues from two major customers during the acquisition process of MRV was a hard hit. However, we responded immediately and adjusted our cost structure to the current sales levels without jeopardizing any activities that are important for our future. On the positive, Europe is maintaining strength, the metro core cycle and our enterprise business are both healthy. The acquisition of MRV has been completed and the integration of the company, our new team members and friends is progressing well. We have expanded our customer footprint and already see first examples of cross-selling success. We strengthened our position in the Ethernet access market and we will leverage substantial synergy opportunities. Overall, our mega growth drivers, cloud and mobility, keep driving the demand for more bandwidth in networks around the globe. The increase in bandwidth demand fuels our industry and is met by a high speed of innovation and price erosion. We respond with innovative solutions that connect, extend and assure the cloud. Near term we will see additional opportunities arising from our leadership position in cloud access and synchronization. We keep a tight control on our OPEX and focus on a quick return to growth and profitability. Thank you for your participation in today's call and with that I'd like to turn the call over to the operator to begin the Q and A part of the call.

Q AND A SESSION

17:15 Robin Brass (Hauck & Aufhaeusser)

Yes hello and thank you for taking my questions. My first question concerns the Q4 outlook: How much of MRV sales are included in your guidance? And also the afore-mentioned M&A ramp-down of one of your clients in Q3, is that expected to come back in Q4? And secondly more general, the afore-mentioned price erosion and innovation in the market that basically is also hampering growth overall, is that expected to ease in the future and maybe become better next year? Thank you.

17:49 Brian Protiva

Uli, do you want me to answer all three or you answer the first one and me the 2nd? What do you want to do?

17:54 Uli Dopfer

I can do the first one. So we expect MRV sales to be between 14 and 16 million in Q4.

18:02 Protiva

So our carrier customer you asked – we do believe there will be some return and that we are continuing to get must have deliveries. They have taken down their inventories; particularly those inventories are fairly empty at this point. And we do believe that ordering will pick up throughout the quarter and hopefully get back to normal rates in Q1 2018. And then the pricing pressure and whether it will ease in the future – yes, I mean the pricing game fluctuates based on innovation cycles, investment cycles and competitive position and right now I think the 100 Gig has come out and we are pushing it; from a price perspective it is at a pricing right now where we can handle the greater bandwidth growth and therefore the overall markets don't seem to be growing too quickly, maybe a few percentage points is the general consensus, it is not 8 to 10%, it seems to be more like 2, 3, 4, 5%, but that will move back up, if anything, bandwidth is growing faster. And all the applications are still coming that we have talked about, whether it is future things like augmented reality and autonomous driving and IOT but just the basic cloud transformation where everything is moving to the network to be connected, is all pushing our business. So I think it is more a couple of quarters slow-down, maybe also pushed there because of China over-investing about a year ago for six to nine months, so we feel that 2018 will be normal growth rates as in the past.

19:55 Tim Savageaux (Northland)

Hello, first I actually missed the answer to a question I wanted to hear if possible which was if you have any specific guidance for guarding the MRV contribution for Q4?

20:08 Dopfer

We said it was about 14 to 16 million, in that range.

20:12 Savageaux

Sorry, offline for a minute.

20:15 Dopfer

No worries.

20:16 Savageaux

Okay, following on this, and I don't know whether there was an impact here in Q3 as well, but I imagine MRV by itself has got sort of an accretive impact to gross margins, so I guess as you look at Q4, which is pretty in my view, rapid return to fairly solid profitability here, to what extent are you looking for this kind of gross margin accretion from the MRV deal, any additional mix driven, and then from an OPEX perspective you did see some lower than expected OPEX in Q3. Did we sort of front end load restructuring benefits to some degree there or does a lot of that or most of that 20 million annualized kind of lie in front of this as we look at Q4?

21:11 Protiva

I believe yes, there is positive coming after the gross margin, definitely positive contribution coming off of MRV already starting in Q4, it is slight but we see already we turned the ship. I think as you have always indicated it is a very strategic acquisition that is going to help us, both on growth and margins and profitability. So that is important. I think we had restructuring of 8.4 million, we have cut quite a few things but no we are still in the process of pulling the full 20 million together for a run rate in 2018. We want to enter 2018 in that kind of a modus, right now and maybe Uli can answer this in more detail than I can but I would say that we are more than 50% of the way there, more like two thirds of the way there but further changes, optimization are happening as we speak.

22:09 Dopfer

Yes, I guess there is not much to add but pretty much accurate.

22:13 Savageaux

Okay, great. And then over on the kind of market facing side, you noted some pretty solid trends continuing in Europe on both the carrier and enterprise side. But I think the answer to that last question was focused on your large carrier customer on the M&A side coming back to normal within a quarter or two. Over on the cloud side I wonder if you could give us an overview of where we stand from a CloudConnect standpoint in terms of that transition and kind of your current view of the competitive landscape – it certainly seems like overall market demand remains there despite pauses here and there from large customers but on a high level that demand seems fairly healthy. So do you anticipate a return to growth from the cloud side here or what should our expectations be?

23:15 Protiva

So, I think the way I view the cloud is that it is a huge opportunity, I think they took a little bit of a pause as we have seen from a couple of the other network equipment providers have stated and I think that is just somewhat cyclical and players are rolling-out mass of global data center infrastructure. So, yes, I do believe that is a long-term growth opportunity. As far as us specifically, I've indicated this a few times, we have not lost our big customer or we have two of the big ICPs, in the mean time we have three. The issue was though, the larger sized ICP customer we lost the application space that represented the most revenues. In the mean time we won two other application spaces back, we won two new opportunities at that customer but they are much smaller. But I reemphasized that because we are a strategic vendor, we are winning other pieces and we are going to compete in the future for that application space which is short-reach DCI or metro DCI connectivity. We have shown that we won a new footprint at another major ICP for an application space, it is not huge but it is in the millions, allowing us to have contracts, have relationships and position us showing what ADVA can do as a supplier. And the second largest ICP customer of ours that is CloudConnect and that is being used in infrastructure, metro and short-haul applications and that is as steady as it goes. So in general we have the problem that no, we cannot turn that around anytime soon because we had massive business last year at this time in that one application space and especially and especially at our large ICP customer. Having said that long term I think it will be a very important application space for us and we are focused on winning further foot print and using innovation to get recognition and to build our reputation with those players so that we can drive lots of revenues mid to long-term. And the final piece of the answer is, I will repeat what we said and that is we don't believe that we really have then growth again because we need to get into that one application space to have growth of our peak numbers second half of our Q3 of 2016, until the end of 2018 where we believe we can compete effectively for that application space. So, in general, it is not bad news, from getting more foot print, getting more opportunities, it is not good news as far as just topline dollar contribution. As everybody can see though you see our gross margins now increasing, quarter on quarter, and if you look at our total gross margin contribution, Bruttomarge, there is a drop-down but it is not a fundamental drop-down like in our revenue rates. And you will see at the growing Bruttomarge or gross margin over the next quarters going forward. And you will see 2018 being a much stronger year than 2017 from a gross margin contribution perspective. So we are putting things to bed, refocusing the business, optimizing our costs and we are going to benefit from some of the things that I just spoke about.

26:38 Savageaux

Great. And just a couple quick ones in closing from me: Where do we stand with regard to cloud revenue contribution in the quarter, and I would imagine to the extent that you came in towards the low end of the pre-announced guidance range that it was incremental cloud weakness that drove that?

27:02 Dopfer

It is about 10% of revenue.

27:08 Savageaux

Okay, and last one from me: I was actually at a show in Denver last week kind of focused on the cable industry and there does seem to be a pretty significant opportunity emerging in coherent optical transport in the cable vertical and I don't know if we have talked about cable, kind of as a customer vertical for ADVA that much in the past but I thought I would ask you if you see any significant opportunities emerging among that set of carriers in the US or globally?

27:39 Protiva

So I think yes, we see opportunities in some of those segments; I think we have some highly differentiated products. I think the core optical piece is more challenging at this point because I think they have made decisions in the past, there is no huge RFPs on the street there but I do believe there is opportunity for ADVA to grow our footprint and margin contribution with some of our highly differentiated and innovative products, including things like our NFVI piece or ALM or our Fiber Assurance Platforms, our Sync and Timing architectures and even in other optical use cases. If given the chance we can also compete in the Carrier Ethernet space, so there is an opportunity there, I feel that we are making some progress at positioning ourselves, specifically in the U.S. and hope to drive more revenues in that space going forward but we still have to be recognized as strategic vendors and true innovators. So there is some pieces that still need to be brought together but yes we are quite positive on the MSO space right now.

28:56 Operator

There are no further questions.

28:57 Protiva

Okay, then we'd like to thank everybody. We will be back in touch shortly with the analysts clearly available for Q and A or meetings over the next few months. And I look forward to seeing you and hearing from you in the next quarterlies. Thank you.