ADTRAN

February 14, 2018
1:20 PM EST

Doug Clark: All right, great. Thank you everyone for joining. My name is Doug Clark from Goldman Sachs on the Comtech and Hardware Team. I'm very pleased to have Roger Shannon here, CFO of ADTRAN. So Roger, maybe I'll start with a higher level question and if there are any additional thoughts that you want to add in to kick off, we can do that at the end with about five minutes left, I'll see if there are any questions from anyone in the audience so just keep that in mind.

I guess the first question is we do a lot of work on the carrier capex environment and there's been a lot said particularly from AT&T. So I guess my first question is, when we look at it, it looks like a more enticing or robust potential spending environment. Would you agree with that and maybe I'll start there?

Roger Shannon: Yeah, we -- again, thank you for having us Doug and I want to apologize to everyone for the voice, I have a little bit of a head cold so I apologize. But we agree with that. We are seeing what we believe to be a stronger capex environment, you know, particularly across the Tier 1's and Tier 3's. You know, our engagement at ADTRAN across the Tier 1's, across both the carrier and the MSO space really has never been stronger in the history of the company. Both those domestically and particularly with the name that you mentioned where we are coming up on a G.fast rollout, the MSO's, but also internationally. We're seeing a similar thing in Tier 3 where you're seeing more interest in a fiber to the prim as well as starting to ramp up the A-CAM model under a [Connect America side]. Where we're seeing, I've been seeing some challenges and continued challenges is in the Tier 2 level with the carriers. They've, of course, had a very challenging year in 2017 and not seeing a whole lot of catalyst for change off that at the moment.

Doug Clark: Maybe if you can talk a little bit more into that piece and then I'll come back to the Tier 1's in particular, but on the Tier 2's, is it a function of their budgetary constraints and their cash flows or is it related to where they are with spend in terms of projects because that has, historically, been a very important and probably outsized customer exposure for the company.

Roger Shannon: It is, so we definitely have the lions share in Tier 2's so we think any growth in that area will come from incremental capex. As you mentioned, they have tended to be kind of project specific, one of the Tier 2's had a larger project that wrapped up in 2016 and then as they went into 2017 you know, were dealing with some budgetary and cash flow issues as were some of the other Tier 2's.

So, again, we don’t -- we're not seeing right now a whole lot of change off of that as they kind of continually work through their issues.

Doug Clark: And is the environment as the budgetary constraint and cash flow issues and dynamic continue to persist, I mean, are they still targeting pockets of spend and upgrades, it's just a more measured approach?

Roger Shannon: Yes, it is. So there's two things that we see there. One is obviously their [cap] commitments. We think they'll -- you know, there's still some run rate to ramping of their [cap] commitments and now that we've gotten past the initial two year where they had to meet 40% requirement, they had the annual 20% hurdles and [maybe just] talked about reaching that and the second component that we're seeing is really more strategic investment around certain projects and they each have some things that they have talked about and there are things that are in discussion. So it's really more strategic and, again, more [cap] commitment related.

Doug Clark: Okay, that makes sense. As we look at 2018 kind of holistically or just the outlook over the next year or so, you made a number of comments on the earnings call than alluded to kind of opportunities that you see for the company. Could you walk through some of those and perhaps kind of the biggest ones that you see as growth sectors for ADTRAN in 2018?

Roger Shannon: Certainly. So, where we see the greatest opportunity in 2018 and in the near future really is within the Tier 1 carriers, both in the carrier space and in the MSO space. You know, we're getting very strong acceptance with our Mosaic platform and software defined access and all of the technologies that we're deploying and building, you know, currently from NG-PON2, XGS-PON, G.fast are all based off of that platform and that technology. So -- and those are just some of the technologies where we are seeing opportunities. You know, we've talked about the G.fast rollout in Australia at NBN where we have a firm purchase order in hand. We expect to start shipping that kind of around mid-year and we've got a commitment for a second purchase order and so this is a large scale fiber to the basement deployment of G.fast in Australia.

And the largest carrier in the world here in the U.S., and we've talked about G.fast for some time, we have began shipping out of region and they stood up a Salesforce for that business and in that because it's out of their footprint. They do -- it is kind of success-based and they go and sell to customers. We expect to start deployment of [in] region around mid-year this year which would likely be the larger opportunity of the [in] region and all of our conversations with them have been that they are very bullish on this, that it's focused initially on multi-dwelling units where if you look at the statistics anywhere from 30% to 50% of the population of America lives in MDU's and G.fast is just ideally suited for that customer that you don’t have to go into each individual unit, tear out plaster or drywall to run fiber but can use existing infrastructure of copper or coax by simply running the fiber to the basement and then picking that up and still delivering near gig speeds or gig speeds over that.

You know, there are a number of other initiatives going on. Obviously the NG-PON2 which we can talk more about where we feel very well positioned on that. We think that's going to be a very significant opportunity going forward over a five to ten year period across a number of applications, you know, not just the current application that Verizon is talking about for low cost internet but we've talked on multiple occasions about it being a catalyst for 5G fixed wireless and 5G backhaul deployments.

The XGS-PON opportunities that are underway and we're finalists for as well as with the MSO's where we've put a lot of effort into kind of gaining traction and diversifying your customer base where we are you're seeing successes on EPON acceptance and deployment as well as with the largest carrier in the MSO space where we're working on some remote OLT functionality.

So you know, just to summarize, I'd say the Tier 1's are very customer diverse and geographically diverse and, again, not to mention our largest European Tier 1 where we -- as we talked about over the course of the last couple of years finished up the vectoring rollout is expected to start rolling into super vectoring into the beginning of this year and we have good visibility into that really through 2019.

Doug Clark: Okay, a number of those I kind of want to come back to and touch on. Certainly one that jumps out to me is just a discussion on cable MSO's and correct me if I'm wrong, but I don't think ADTRAN has historically had a large position supplying into those customer base. So what is changing and why is that becoming a more realistic opportunity at this point?

Roger Shannon: So if you look at the customer statistics, the cable MSO's have been holding steady to increasing customers now all of the providers are dealing with over the top and cord cutters which is impacting their video but at the same time driving the need for broadband access. So, as we looked at that we're obviously a very strong player in the 40% or so of the market that the carriers cover and carriers are obviously having to respond competitively to the threat of the MSO's but we knew that we needed to be a much stronger more relevant player in that 60% of the market that the MSO's take up.

So it really started with our acquisition a year or so back of EPON and RFoG products that you kind of get our foot further in the door with the MSO's. We already had a very good relationship with Comcast really more from the enterprise side but this has been a bit of a game changer for us in kind of furthering those conversations and making the significant end roads into the other carriers that are unlike Comcast who are going directly to EPON where we're engaged in -- even with the largest one who's doing a fiber deep DOCSIS 3.1 approach. They are looking at it at a different structure more remote [OLT] environment technology where we're very much engaged in that. So it's just kind of an opportunity that saw where we could use our domain experience from broadband and expand on the relationships we already had and we're seeing good success with that.

Doug Clark: A question that I get occasionally and that ADTRAN will tangentially touch on is just the topic of 5G and you mentioned with the specific technology NG-PON2, basically as we move to faster broadband speeds, more network flexibility and the 5G world, what is ADTRAN's place in that, I mean, what equipment is used for it and what needs to happen from an equipment standpoint to see that realized?

Roger Shannon: Well, we see 5G certainly as a catalyst for significantly -- you know, several orders of magnitude, increases in fiber deployments, we believe that NG-PON2 is ideally suited for the 5G environment and just to briefly touch on NG-PON2, the technology encompasses a 40 gig pipe that's split into four ten gig wavelengths or colors, if you will. So, carriers like Verizon who today have different fiber networks for mobile, for residential, commercial or enterprise that are running over different, the objective is to get that on to

one and NG-PON2 permits that. So, wave splitting of four different wavelengths over one band is ideally suited for brining all of those together on one. So if you think about the premise around 5G and standards developed, what you're going to see just by the nature of the higher wavelengths is they don't go as far obviously as the 4G LTE so you're going to go from having tens of thousands or hundreds of thousands of towers to, you know, millions of small cells and that's going to drive a tremendous amount of fiber requirement and determination. So that again it's -- you could on one hand say does 5G present a challenge in (inaudible) to more of a wireless, we see at the offset we see an explosion and a need for fiber access termination to push those small cells out and in the second area of engagement for us is on fixed wireless. We had a press release that we put out in October of last year where we announced an initiative with a -- kind of when the premier fixed wireless vendors that has a kind of disruptive sell-organizing mesh technology. We're working with a number of different fixed wireless vendors across tens of different fixed wireless opportunities.

So we see that as not only 5G fixed wireless but rural broadband access as well.

Doug Clark: Okay. I want to touch on now your largest customer and, you know, the dynamics have been a little bit more challenging recently, CenturyLink has caused a pre-announcement on the fourth quarter, a bit of a weaker first quarter guide on the earnings call the commentary was we're basically waiting for visibility to -- if and when they will return spending. Has that dynamic changed any more further now until their 90-day review process, what is the latest update on that customer?

Roger Shannon: Their -- as I understand it their review process is still going on. We're in very active dialogue and conversation with them. We're helping them better understand the opportunities in kind of competitive dynamics of a hundred meg vectoring versus other scenarios. Unfortunately I don't have any new news -- to come out with their plans and their capital budget for the year but we remain very engaged and we have very much we're in ongoing conversations with them.

Doug Clark: And it seems Calix, one of the competitors aspiring to a CenturyLink kind of indicated similar limited visibility at least on the near-term basis. Can we just touch on the -- what are the potential outcomes here, they return to spending fully, scale back or shift to alterative technologies, anything else in terms of range of potential outcomes?

Roger Shannon: Yes, so on our call we laid out what we think is four general scenarios. On the bookends of it, on one end would be just a return to the vectoring program that they had originally started in the beginning of 2017 and it was scheduled to go through 2019. On the other bookend of it is that they pull back from consumer broadband access which we don't think is likely given the comments that both the current CEO and the incoming CEO have made in their calls and their transcripts. So, the middle two cases, one being remaining with vectoring but taking a more targeted approach, they've talked some about their observations around customer uptake, the customer uptake is better where the access speeds are closer to the 100 meg versus, you know, 50 or below. There's been -- I think there was a story out the end of last week about how there is a -- kind of a lack of competitive's at the 100 meg speed. There's very much the opportunity or possibility that they would take a more targeted city, neighborhood customer approach to where they can deliver those higher speeds and see better customer acceptance. The other scenarios that they decide to pivot from, copper based vectoring technology toward more GPON, we

believe that we're well positioned on that as well. So, again, that's kind of the wait and see dynamics is which direction they intend to go.

Doug Clark: And I mean depending on the return of the customer, again, they have been your largest customer for an extended period of time and we're seeing the financial impact especially in the first quarter from a gross margin and profit standpoint. How reactionary does the company -- does that trend become depending on once you start to get more visibility to the extent that it doesn't fully return?

Roger Shannon: Yes so again it's -- the challenge really is more around timing given the opportunities across the Tier 1's and also Tier 3's that we've talked about and we have really in front of us. You know, ADTRAN is very cost and profitability focused, we've always been profitable. We certainly will take whatever steps necessary to kind of keep that cost dynamics within control but really we see it more again as a timing issue given the opportunities that we have.

Doug Clark: Okay, and the final question on this, when would you expect to have visibility into this? When is that review process done? I can't remember if it was --

Roger Shannon: Yes, they had indicated to us toward the end of the fourth quarter when the official communications came through that it would be kind of a 60 to 90 day review process where we're within that window now so we certainly hope to hear within the first quarter.

Doug Clark: Okay, okay. On the Tier 1's in the U.S., you talked a little bit about AT&T and G.fast and then Verizon on the other hand is being more of an NG-PON2 potential customer. I'm curious where you are with them on qualifications and product testing and the reason that I ask ultimately is Calix did announce that they are in commercial deployments with Verizon. So what is the opportunity, where are we from a timing and really entry standpoint?

Roger Shannon: Yes, so as I'm sure everyone knows, Verizon did a large RFP for the NG-PON2 project. They selected two vendors; ourselves and Ericsson Calix. We've both been extensively involved in development over the past several quarters, let's say -- we've talked about in our quarterly calls and in our opex project specific expenses so it is a labor intensive and cost intensive technologically challenging exercise as you would expect.

We're pleased with how it's coming along. We certainly would have liked to have been the first going to FOA is the clearly announced the first one in Tampa that we'll be starting. But this is a potentially very large project that will go over five to ten years, there are numerous more FOA's that are planned for 2018 and beyond. We're very much engaged with them, in the lab with them and feel very good about where we are and we're targeting coming out of the lab and going into FOA kind of mid-year this year. So, would we have liked to have been first? We would, but we feel very good about our position and feel very good about the opportunity. You know, for both -- for the customer as well as both providers, there are still technological and commercial hurdles that have to be overcome and I think the customers talked about that, getting to the price point that they want on the [tunable] optics and the [ONT] so there's still quite a lot of work to be done and we feel very good about our progress on that.

Doug Clark: Okay, and just actually even taking a step back on AT&T and Verizon, I mean, these

were, if we go back, several years, these were 10% large customers for ADTRAN, it seems like both respectively have a reinsertion point, AT&T is already picking up. I mean, are the sizes and scopes of these projects that you're involved in, you just mentioned five to ten years for Verizon of a material size to where we could see kind of similar levels or at least materiality that we saw in kind of history of ADTRAN?

Roger Shannon: In a short answer, yes. And we've talked about this on our recent call, AT&T, Verizon as well as NBN, you know, all -- most certainly have the opportunity to be 10% customers, we expect all to be material going forward.

Doug Clark: Okay, and actually NBN was my next question. The Australian NBN project has been around for years and honestly [has] kind of materialized to the extent that I think people or suppliers or investors would have expected. So why now, what has changed, is this really happening and what happened to make this an opportunity for ADTRAN because it's only been recently that the company started to talk about it?

Roger Shannon: Yes, there were a lot of fits and starts to this project. Doug as you know I came on at ADTRAN about 15 months ago and one of the first things that we were talking about and started my tenure was this NBN project. A couple of things really more on the fit side of it, one being the political environment and it's a very interesting dynamic there that they have conservative and liberal parties like we do. The (inaudible) conservative party tends to be more, you know, physically sensitive and they were focused more on this G.fast fiber to the basement technology whereas the other party was more fiber to the prim. The fiber to the prim had been tried, spent a lot of money on it obviously it's a very large country. And there was a kind of a period, a political period, where there was some uncertainty. (Inaudible) party ended up staying in power and the project came back on. At the same time, there was a local provider, NetCom who was given the initial award for DPU's and as it turns out they were not technologically at a point of being able to do the G.fast. So they pivoted back to us, gave us the award for that, we actually have a firm PO in hand that we expect to start shipping around mid-year. We also have a commitment for a second PO and we're hearing that there's been some incremental expansion to the number of homes that they intend to pass in Australia with this technology.

So, again, after a number of fits and starts over a couple year period we're at the point where we're moving forward.

Doug Clark: Okay, that's encouraging. And then last kind of international question is just Latin America. What is the status of the markets, in your views what are you hearing under your customers?

Roger Shannon: Yes, so our largest customer there, Telmex, has been caught up in some anti-trust competitive dynamics with the Mexican congress. It's a similar dynamic to what played out in the U.K. with British telecom and open reach. There's been, again, following the news some incremental progress than that but kind of given that regulatory uncertainty they had they completely shut off all of their spending and particularly growth, capex, capex growth. You know, we expected that in 2017, actually 2016, for that region to offset some of the weakness that we knew was coming in in Europe as this vectoring project wound down and new projects were about to come on, had a number of things in the lab with them when they pulled back. So that really hasn't changed. We still are very

much engaged with them, we have a number of things in the lab, they could come back, you know, any week. We've traditionally had very limited visibility, unlike the European Tier 1 where we have longer term visibility, things tend to come unexpectedly. So you know, that's the good news and the bad news. It's right now it's nothing but upside, zero, the bad news is we just don't know when that could happen.

Doug Clark: Okay, actually last customer question; Deutsche Telekom, the longest German kind of European customer, you mentioned super vector so they're pivoting from, I think, three or four years of vectoring rollouts, it's super vectoring. In terms of scope and comparability, is it larger or comparable size, any way to kind of engage that?

Roger Shannon: Yes, that's a good question. I -- my expectation would be a fairly comparable size and you can think of it as going through the territories, rolling out vectoring which is 100 meg speed, that projects completed so now they're coming in behind that and replacing vectoring cards, vectoring technology with super vectoring which is up to 350 meg speeds. Again, it's a multi-year project kind of areas that they're focused on, will be rolled out. But it is a very important project for us.

Additionally they have -- this is an announcement we made last year, they've awarded us a copper to the basement award where they're going to take or we're going to help them take bonded super vectoring from the node to the basement, install our G.fast DPU in the basement and then go from a super vectoring feed into G.fast and to multi-dwelling units using installed copper or coax. So that's something that we are working on for 2019 and forward.

Doug Clark: Changing gears a little bit, Mosaic and software defined access, so ADTRAN's been working a lot on kind of the flexibility and programmability of its solution. I'm curious, is there a direct monetization of that solution or is it enhancing the holistic kind of portfolio product offerings of the company and then more broadly kind of -- what is the engagement and interest level from customers and how has that been received?

Roger Shannon: Well it's -- so I'll start off by saying that Mosaic has been incredibly well received both by customers and by the press in the industry. It's got 13 awards, it's the most awarded software defined network access in the market right now. It is part of the largest deployment of SDN by AT&T as part of the G.fast where they're using it both in region and out of region. And as well as with other deployments that we have across a number of different continents. So, it is being monetized, it is not -- we're certainly not at a point or we don't think in the near to medium term at a point to where it shifts to more of a software as a service. There is that push, as you know, towards more Open Source, WhiteBox but we -- and I think everyone accepts that will happen just no one knows when.

So we think it will at some point but we're not there yet. We are monetizing the software but it's still, again, pretty much, very much, as part of the overall package but incredibly well received. You can think of it kind of like the way that Uber or Airbnb has transformed the transportation and housing industry. It allows carriers, and AT&T has been one of the primary ones to do this, to move toward more Open Source, Whitebox hardware to disaggregate the control from the hardware itself, have it more customer-driven with lower cost interoperability, faster turn-up and it's really -- it's a different way to think about deployment and the service delivery platform.

Doug Clark: In that sense, this Mosaic (inaudible) combat the potential kind of commoditization of a Whitebox architecture?

Roger Shannon: Yes.

Doug Clark: Okay. I'm going to ask one more question and then folks have questions in the audience, I'll check in with you. Gross margins? I talked a little bit about it before but the domestic kind of mix shift due to CenturyLink is [pressuring] gross margins. What is your broader outlook for gross margins for the company? I know you talked about a little bit of a recovery so the primary drivers there?

Roger Shannon: Obviously for the first quarter we guided to 40% area gross margin that is lower than where we had been for the past couple of years and that is driven by a lower level of domestic spend and as expected a higher level of European spend and our European Tier 1 tends to be more front-year loaded first quarter, second quarter and we're certainly seeing that with the super vectoring rollout with the guide for Q1 being lower due to that uncertainty that we talked about in the domestic.

The -- as we talked about at each quarter, the services gross margins, as our services business has grown and it's become more network implementation focused, that began to be reported as the separate segment, you know, the gross margins are lower than product gross margin at the GM level but accretive as an operating income percentage just by the nature of less R&D and less opex. So that has, over time, has weighed on kind of keeping the gross margins and (inaudible) has the international business where the impact of (inaudible) who's not allowed to compete in the U.S. for competitive security reasons where they do compete in Europe and in Latin America they tend to have a dilutive effect.

We consistently said that we expect and think that we can be in the 46 to 47 area, that's certainly our target in gross margins. We have, you know, scale at the gross margin level as revenue grows as well as at the operating income level. So that's where we've had some volatility in the short-term, again, the longer term opportunity and picture remains intact and that's still our goal.

Doug Clark: Okay. So geographic mix is one factor, scale and revenue overall. What about in other com equipment spaces, the razorblade business model is an impact. So when we talk about AT&T, NBN, Verizon, Deutsche Telekom kind of moving into the super vectoring, are there lower margins on the upfront shipments or is that maybe less meaningful than the other two things that you talk --

Roger Shannon: There are. (Inaudible) comes to play. We saw that in Q1 of last year when we got a new Greenfield award from a large European Tier 1, that initial shipment of the chassis and system level vectoring cards, was it a larger margin and then as we start shipping the razor blades, you know, the cards, that tends to be at a richer mix. So it is project by project, customer by customer specific. I'm not to a point where I would say that's the same dynamic on GPON or EPON is that it's kind of different technology with the OLT's have to be deployed before the ONT's which are more success based and given the very large number of ONT's, that tends to be at a different margin point than the OLT's.

So it -- there certainly is that component that we will always have that at different stages of the project deployment.

Doug Clark: Okay, I think we have time for one question. Okay, that would come from me. Capital allocation, the company is sitting on a decent amount of cash. You've done acquisitions in the past as well as kind of buybacks in the steady dividends, and any preference for any of the three at this point?

Roger Shannon: So at this point there's been no change from our board from the position that returning cash to shareholders through share repurchases has been kind of the preferred approach. We are opportunistic in how we go about that. We don't have just a kind of a blind systemic process in place but we have been very consistent in returning cash through share buybacks on acquisitions. We don't feel like we need to do acquisitions from the competitive standpoint. We have posed it really more as a customer-broadening product portfolio broadening technology [fill-in] and we continue to look at things as we have done.

Doug Clark: Okay, perfect, that's exactly our time. Thank you very much for coming and thanks everyone for joining.

Roger Shannon: Great, thank you so much.