ADTRANInc

February 13, 2019
02:40 PM EST

Rod Hall: All right, so thanks for coming, everybody. I'm Rod Hall. I'm the IT, hardware, and networking analyst at Goldman Sachs. Got the great pleasure of having Roger Shannon here with us from ADTRAN, the CFO of the business, so welcome, Roger. Thanks for coming.

Roger Shannon: Thank you, glad to be here.

Rod Hall: So I guess I wanted to—there's a whole bunch of topics to cover, most of which relate to telecom networking and a lot of which relate to 5G, so I want to kind of kick off there. So we've written quite a bit about fixed wireless access, and we're very optimistic about the fixed wireless access opportunity with 5G, but I wanted to kind of throw it over to you talk a little bit about the progress of fixed wireless access in the US. You've talked about a big project in North America, so I wonder if you could elaborate on kind of where that stands. Do you see it delaying a little bit? Do you see it going forward? What's going on with fixed wireless access in the US?

Roger Shannon: Sure. You know, we see the opportunities across fixed wireless accelerating, really on call it three fronts, the submillimeter wavelength for applications like CAF and extended range for 4G or below, as well as the millimeter wavelength, 26, 28 gigahertz, and then going up to 60 gig (inaudible) spectrum. So we are seeing, you know, as you alluded to, we are working on a couple opportunities that we talked about in our last call in the US. We've seen really increased interest in RFIs, RFPs across Europe as well as the US, and we're working with a number of different providers, really depending on the application and the technology.

So we've kind of placed our bets across several different providers. We do have a partnership with one, an interest in one that we believe has kind of the lead position in development of the 60 gigahertz radio, spectrum radio, and we're excited about that. So that, you know, that opportunity certainly is continuing to receive more opportunities and not fewer, and you know, we're continuing to work with our partners to get that further developed and fleshed out and respond to these increasing number of RFIs, as well as to continue to kind of bake the functionality of fixed wireless into our Mosaic cloud platform.

Rod Hall: Okay. Let me ask you this: We have an opinion, but it's an opinion of an analyst, so it's always good to ask a guy in industry like yourself. Fixed wireless really looks like a disrupted business model for the telecom world, to us anyway, in the sense that it lowers that cost to get high-speed broadband access out to a home. And that, we think, attracts more competitive behavior, at least in North America, and maybe elsewhere as well. Just curious, could you comment a little bit about just how you see fixed wireless access and 5G affecting the industry? Do you agree with that? Do you disagree?

Roger Shannon: Yeah, I would say I don't fully agree with that, at least not yet. There are still physics challenges around 5G in that—and also license spectrum challenges in that that really hasn't fully been fleshed out yet. Now there is one of the larger US providers that has, at least from a marketing perspective, started to go all in on 5G as it relates to mobile. The second large US kind of seems to be coming along because they have to. But I do think there are still some physics challenges around just the promulgation of the wavelength.

We do agree, and we do think that it is going to be—you know, once those issues are ironed out, we do think that it's going to be a viable alternative for much more dense urban areas as opposed to suburban and rural. We do see, and we are working on opportunities for, submillimeter fixed wireless for some CAF-type applications to where it's more cost effective, or from a timing perspective more effective, to get that deployed as opposed to a traditional wire line.

But within the, call it the suburban, the consumer areas, the less highly dense urban areas, you will still see the fixed wire lines being the more economic approach. We're seeing continued development and interest and proposing (ph) requests around that.

That said, we are working and talking about opportunities around millimeter wave fixed wireless, as we just discussed, and we do see that as being an option. But I don't think we would at this point agree that it's going to be a complete disrupter to fiber to the home, where we're certainly seeing much more interest across our domestic, international customers.

Rod Hall: Okay. Just a question; on the suburban and rural, I would have thought if the price to pass a home comes down, that those areas, those less dense areas, you would work your way out from dense to less dense, and the lower cost would—could you say a little bit more about why you don't think it works in those areas?

Roger Shannon: Well, just because the nature of the millimeter wave is short. So, you know, we do see opportunities, particularly 5G backhaul, and I didn't mention that, but we do see substantial opportunities for that that we are working on. At this point in time, the way we see it is it's still more economic to just kind of run the fiber to the location.

Rod Hall: So you still get into the problem of too much capital deployed for too few potential users?

Roger Shannon: Exactly. And when you add the topology and the distance to that, there are still a lot of challenges around it.

Rod Hall: Do you have any view on what proportion of the population we're talking about that's reachable? Kind of a—we didn't talk about that question ahead of time, but I'm just

curious if you guys have looked at it.

Roger Shannon: Well, you know, there's—the statistics we see is that—and you know, this is as it relates to broadband access in general and what the federal government, the FCC is trying to get covered—we're still under 70 percent of the population that's covered by 25/3, as opposed to in the more dense areas it's almost 100 percent. But I don't have a firm view on what the number is. I think it still just depends. I think as we're looking at CAF applications in particular, there are a number of opportunities where the topology presents itself to where it is less cost effective to reach by traditional wire line for that 25/3 requirement to use submillimeter fixed wireless, and we are working on some of those opportunities.

But, again, we're taking—we continue to take a kind of all-of-the-above approach, and we don't see it being that displacive (sic) or that disruptive yet.

Rod Hall: Okay, let's talk outside the US on the same topic. We haven't heard—we know in Germany there's some interest. Beyond that, we haven't heard of too many other places where there's a lot of fixed wireless interest. Does that match what you're seeing, or do you think there are others out there internationally that are taking a hard look at it, will probably end up spending some money?

Roger Shannon: Yeah, no, we're certainly seeing more. We are aware of the one you mentioned, the large European carrier that has interest, RFI in fixed wireless. We have seen a pickup recently in more of those RFIs, RFPs across a number of different European countries that we expect to participate in.

Rod Hall: Right, okay. All right, so a little bit more hopeful there than—a lot of people don't think Europe is really going to do very much, at least the European—

Roger Shannon: Yeah. Again, it's early days on those, so there is interest and, like I mentioned at the beginning, with the partnerships and the development we have going on, we think we're well positioned for it as it comes.

Rod Hall: One of the things we've seen with 5G as well is architectural change. It's not necessarily 5G related. We see it as more 5G being used as an excuse to spend money on an architecture shift, and that shift is—there's a lot of software orientation in that as far as we understand it. And I guess this is—you know, we're thinking of a particular carrier, but then I think that will be a precursor to more of this sort of architecture deployment in the industry. One of the things I wanted to ask you about is how you feel about your competitive position as that architecture shifts. Do you feel like you guys have the right technology, the right platform to address that, or do you feel like there's more development needed to be in a good position there?

Roger Shannon: No, we do feel like we're in a good spot for that, because if you think about 5G, really, there's three areas. There's 5G mobile, 5G fixed wireless that we've talked about, and 5G backhaul. So particularly from the perspective of fixed wireless that we have been talking about and the backhaul as well, including the software platforms for that, we are very much focused on that and very much in development on that with our R&D group. I think everyone's certainly aware of the NG-PON2 opportunity that is still very much in play for

us and very much engaged in and working to move forward. Obviously, there is 5G backhaul opportunity with fixed wireless, as well as across XGS-PON, which we think we're well positioned for.

Rod Hall: Okay. I wanted to just see if you could talk a little bit—I mean, you talked on the call about maybe a pickup in activity at CenturyLink in the US in Q4. That's been really weak in 2018. Can you talk about what you think happened this year with respect to them, and do you see growth again? Do you think it deteriorates, but not as fast, or what are you thinking there?

Roger Shannon: No, so the low point after their kind of merger-related slowdown happened in Q1 of 2018, and for every quarter, customer remained a 10 percent customer for us. So it didn't—you know, it certainly didn't drop to zero or even an un-meaningful number. It did drop to a much lower percentage of where it was when they were doing a multi-year, multi-city vectoring upgrade and rollout. But we do have ongoing business, and we saw sequential increases each quarter across 2018 across really all the fronts that we're working with them on. Vectoring has resumed in some locations, and it kind of has played out like we expected, in that we expected it to be more project-by-project, neighborhood-by-neighborhood as opposed to a large-scale, multi-city that it had been.

So vectoring has resumed. We are in the lab with super vectoring in G.fast. We are doing GPON business, and of course CAF and other business as usual has continued, and like I said, to pick up sequentially across 2018. We see that being—we do see that growing over the course of 2019 going forward, as those projects continue. You know, we're about 60 percent through the CAF spending across the US, I'd say in general, for CAF recipients. And then, there are some other projects that we are—in addition to the items in the lab that I just mentioned, some other enterprise-related projects that we're engaged with them on and we expect to see materialize across 2019.

Rod Hall: Could you just talk a little bit on this subject of software orientation? Just remind us what your technology platform looks like and whether there is software-based routing, some of these, you know, functions that fakes (ph) out the access side of things, whether they're virtualized today on your platform, and if they're not today, kind of what's the general thinking? I know you're CFO, so I don't want to get too deep in the weeds, but just want to kind of check what you're thinking about the state of the platform, I guess.

Roger Shannon: Yeah. No, I appreciate the question. I think it's a great question, and we've talked quite a bit over the past year, and really over the past couple years, about our Mosaic cloud platform and Mosaic OS. You know, just remind everyone that Mosaic—our Mosaic cloud platform SDN is the most recognized, the most awarded SDN platform in the industry, up through and including the latest awards given out across 2018. But, in practicality, what you're seeing is there is not really any meaningful number of carriers that are ready to say I'm at a state of disaggregation to where I'm buying the software and not buying the hardware. We just don't see that materializing, really, at least at this point.

We think that the SDN platform was crucially important, and we did spend a good deal of effort to get to where we are with SDN. Now, I think it's important to note that our last acquisition that we just did in December of SmartRG really ties into that software expectation and platform development that we're talking about in that we were arguably

kind of behind as it relates to the routing that you mentioned, the CPE virtualization. And through our acquisition of SmartRG, who we believe had a couple-year head start in that area, that's kind of caught up and we'll be able to, again, leapfrog on that area.

You know, and even beyond the residential gateway and SmartOS platforms that SmartRG had developed to fill a hole that we had, our plans are to carry that over into our enterprise CPE to build virtualized—you know, further build out virtualized enterprise CPE, diagnostics, analytics, software as a service, and enterprise cloud platforms. So that really is going to help us accelerate that, so much so that you may have seen that in our last earnings call, we highlighted the fact that we have kind of repositioned our customer devices category into a better title of subscriber solutions and experience, really focusing on that experience of the consumer, more of a UX focus, usability, as well as a re-energizing of not just the residential gateway equipment that we have acquired, but a re-energizing of our enterprise equipment that we can leverage that SmartOS software across.

Rod Hall: Right, okay. That's good. That's helpful; thank you. I like cable. Let's talk about cable a little bit. You've acquired some cable assets over time. Can you give us some idea how big the cable industry is for you today in revenues? And talk a little bit about the opportunities there and how you see that progressing.

Roger Shannon: We had pretty substantial growth in percentage terms across 2018 in the Cable MSO space, obviously with that coming from a lower base. So just as a reminder, we participate in MSO across three areas: one, our CPE that we've had for some time and enjoy a fantastic relationship with particularly the largest carrier, but MSO customers and CPE. Then we acquired the EPON and 10 gig EPON business, first from CommScope, and then from Sumitomo, both of which makes us, far and away, the market leader in the US in MSO EPON to where we're the incumbent with the largest—really the two largest—and able to develop further opportunities with the relationships we have across other domestic and international.

And then, thirdly, the direction that the MSO carriers is moving is toward a deeper fiber, more of a disaggregated, remote deployment that they expect to achieve lower cost on future deployments of, as they continue to not only pursue the DOCSIS 3.1, push fiber into the network, moving more toward an all-IP, all-fiver network environment. So to that front, we were already organically at work on remote OLT RFP. We were able to leverage the benefits of the Sumitomo acquisition, which made us the incumbent with that carrier, as well as software platform and functionality that was already in place as a part of that traditional OLT EPON equipment to be selected by the largest carrier for their remote OLT deployment and development.

We've talked about that we expect that to start to be deployed toward the end of 2019, but until that point, we're the only supplier. So anything that that carrier does up until they start to deploy remote OLT will be EPON equipment that comes from us exclusively. We continue to be in the lab with both the two largest, as well as others on other remote-type products that are going through the pipeline, and we see, really, opportunities, if not the end of 2019, really in 2020 going forward, as they continue to build out their fiber networks.

Rod Hall: Just on the remote OLT, in that RFP that you said you won, did you come in late in that game? We've seen some disruption in other remote PHY vendors that you might be familiar with. I'm just curious whether—do you think that's maybe a competitive disruption, or have you seen broader reduction in spending across that environment, or spending getting pushed out a little bit?

Roger Shannon: Yeah, you know, we have certainly watched with interest the developments of the remove PHY, remote MAC-PHY, and have seen some of those CapEx numbers that we've talked about. We certainly did not come in late to that RFP, but what I would say is that we were able to make some leapfrog moves. There were obviously a number of bidders and potential suppliers to that RFP. We did not have a position with them outside of CPE until we acquired the Sumitomo product. So, you know, certainly from a strategic perspective, the acquisition of that Sumitomo product, both from the incumbency, the deployments, the learnings, the software package, in addition to the relationship was, I would say, very instrumental in our leapfrogging into that being awarded that business, being selected.

Rod Hall: So the first part of that answer, I just want to make sure I understand that. You saying you do see some CapEx pushout in terms of remote PHY deployment, generally, or you don't see it—

Roger Shannon: Well, you know, I—with us not being directly engaged in that, I mean, I've read probably the same thing that you've had.

Rod Hall: Okay.

Roger Shannon: I haven't seen it directly.

Rod Hall: Okay.

Roger Shannon: But, that said, where we are engaged and where we are seeing progress, again, in addition to the award that we were talking about, we continue to be in the lab with other providers, other MSOs, both in the US and internationally, as they continue to move toward remote deployments from OLTs and EPON.

Rod Hall: How big—can you size the remote OLT opportunity at all, or is it—can give you us any idea how, if you were in our shoes, how might you estimate it or model it?

Roger Shannon: You know, that's not a number that I've put out yet. We do expect growth in it from what we had over last year. You know, we've talked about it being—it wasn't—any individual one was not a 10 percent customer last year. We talked about toward the end of the year, in aggregate, it kind of approximated a 10 percent customer. But we see—you know, we absolutely see that growing. And I think, you know, we'll be prepared to talk more about it, but we really haven't given any public sizing of that at this point.

Rod Hall: Okay. I wanted to jump into Huawei a little bit, given all the controversy I guess around the company and, you know, pretty decided move, I would say in the US for sure, and that's kind of been the case anyway, but more pressure on Western allies, generally I think, (inaudible) Huawei. And so, I'm just curious whether you think that creates

opportunity for you. If it does, do you see it now, or when might it happen?

Roger Shannon: Yeah, so we do think the timing is beneficial for us because we've seen a pickup, you know, as we've talked about on our calls and as we just mentioned, and further interest and expansion of fiber (inaudible) opportunities across the (inaudible). Again, just as a reminder, Huawei is not in the US in a meaningful way. They're certainly not in Tier 1, Tier 2s. They're prohibited, under US law, from any applications that has government involvement. They did try to make some inroads into the Tier 3s, and now those carriers are kind of having to rethink that. It was a small amount, but there's some rethinking and opportunity in the smaller—the co-ops in US Tier 3s.

Where we are seeing the opportunity, and I think the timing is helpful in that there is much more interest that we've talked about, these five to ten RFPs across the Europe and Middle East area, for enhanced or additional deployments of fiber to the home that is being driven by competitive pressures from the cable space as well as Gigabit Society (ph) initiatives by their governments. Creating a situation where they are either one of the incumbent providers and those operators are rethinking that and trying to lessen that dependency, or if they're not involved, they're certainly not being asked to be involved in these. And the short answer—you know, short answer would be yes, because we are seeing opportunities from that, and specifically across a number of opportunities and RFPs that we're currently working that we've talked about across Europe and the Middle East.

Rod Hall: Are these accounts where you are already present, or are they place where—don't really have a presence?

Roger Shannon: No. No, they're—so there are some where we are already present that have put out RFPs for fiber (inaudible), fiber in the home. But, you know, the majority of what we're seeing is across new over builders who've gotten funding and, again, are kind of progressively going to market. So I'd say it's a combination, but mostly it's new.

And we have been focused, kind of going back to the late 2017, 208 situation, a lot of our strategic focus and emphasis over the past year has been on a diversification across customers, products, and territories. So while, you know, you wouldn't turn away a customer that represents 40 percent of your business, as we saw in 2018, it's certainly painful when something does happen to that. So we are—and our project, just by nature, is cyclical, project base, so we're trying to work to diversify, to raise that bar or raise that low point of cyclicality. It still will be cyclical, but through diversification of products, customers, and territories that we are aggressively working on, we're looking to minimize that impact.

Rod Hall: Okay, that's great. How about Australia and BN? We talked about that a little bit. Can you give us any idea on size, I guess, how big that might be for you at some point? Any feeling for that? And then, the second question is there's been this media speculation about how to get funded. Any thoughts on that, or can you give us any more insight on what might be going on there?

Roger Shannon: Yeah, so again, we see continued opportunity there. We shipped G.fast DPUs over the course of Q3 and Q4 of 2018. We do have the second PO in hand that we will be

shipping over the course of Q1 to Q2, kind of finish up this first round of DPU shipments. Where we have the next level of visibility is into, what did they call it, NCD or CPE products, where NBN is looking for a second-source provider to the local incumbent there. You know, we think we're well positioned for that, so that's kind of the CPE components of what's been deployed so far.

But I think the bigger opportunity, even beyond that, is as they look past the—call it the 1.4 million homes that they were addressing through this first round of upgrades, there is sort of a consensus, we believe, of gigabit upgrade for a broader base that would potentially reach up to a addressable market of 4.7 or so million homes that would require an upgrade from the VDSL fiber to the node equipment that they have now to DPUs. I think there is—there has, in the past, as we've talked about, there's been some disagreement across the parties as to whether they should do full fiber to the home or G.fast. You know, our understanding now is it's really more kind of broadly acknowledged that G.fast would be the way to approach that.

So, again, we see that being something that will play out after we get past this first round of G.fast deployment, the CPE deployment associated with that, as they then look at potentially a threefold increase in the opportunity for DPUs and G.fast.

Rod Hall: Okay, (inaudible), you've talked about growth in the earnings call. How are you thinking about sustainability of (inaudible) growth this year?

Roger Shannon: You know, that particular customer in (inaudible) has been (inaudible) been dormant for a couple years since they've gone through some regulatory, antitrust type challenges. That seems to have been getting resolved. And historically, it's been a situation where they will come in for large orders, large purchases that they'll then take and deploy. There will be some services work around that. That will get digested, and then we just kind of go from there.

We don't necessarily see that being different this time. It's been a longer drought than usual. They did come back in in the fourth quarter. We do see that business being meaningful for us in 2019, as it continues throughout the course of this year. We expect that there will be some follow-on services around that, and then we remain engaged for their future upgrades. Again, it's been a long period of lack of investment, so we certainly think there are opportunities there and we do have good visibility into pretty material business over the course of 2019.

Rod Hall: Okay. We talked a little—we touched on Germany a little bit on fixed wireless, but I wonder if we could expand to just Europe and European revenue expectations as you've been picking up some Tier 2s there. What do you think happens with revenue in Europe in 2019? Do we see—what's the trajectory?

Roger Shannon: Well, you know, we certainly saw material international growth over the course of 2018. Certainly, a part of that was the impact of our US Tier 1 being down in 2018, but we have been very pleased with the growth we had, both from our large European Tier 1 and across these new opportunities. So our super vectoring upgrade, you know, kind of continued—certainly continued across 2018. It could have been the largest year that we had with that customer. That super vectoring rollout will continue over the course of

2019. I don't expect the large Tier 1 customer would be at the same level as 2018, just because 2018 was so large.

As we kind of continue through the super vectoring, finish that project up, the next initiative there is a project where we've been awarded the trial, which is a bonded super vectoring, then G.fast into the premises. There's also their Access 4.0 and fiber to the home, as well as, you know, potential fixed wireless initiatives, all of which we are involved in.

But what we do see across Europe is, you know, expect European business to be consistent with where we were last year, so any potential downside from the large European Tier 1. We expect to be at least offset by these opportunities that we've talked about across other Tier 2s and other fiber-to-the-home opportunities that we're involved in right now.

Rod Hall: Where do you think the risk to that is? I mean, do you feel like things are going—outside the major customer, things are going—momentum's good?

Roger Shannon: You know, I do. We've talked about this on our call. We see a pivot from GPON to 10 gig PON, you know, not just NG-PON2, where we're win with—been selected by the large US carrier, but XGS-PON, 10 gig XGS-PON, to where we feel like we have a leadership position. So we've talked about these five to ten RFPs across Europe and the Middle East, and we feel very well positioned for those. And those, you know, we expect to play out over 2019, and with deployments either later in the year or into 2020, so we feel good about where we stand and our opportunity for those.

Rod Hall: Biggest risk to growth in '19?

Roger Shannon: Yeah, I think the biggest risk ties in to what we're most excited about, and that is this number of upgrades and opportunities. I talked about and touched on the nature of our business being cyclical and project oriented, so we are—it depends on the timing and the funding of the carriers. So we're certainly working to be more diversified across more carriers and more products. But I think the biggest would be just the timing and deployment of those projects starting.

Rod Hall: Okay. And then, the last question for me, as we're almost out of time, consensus (ph) forecasting 3 percent margin in '19. Just wondering what you think about the leverage in the model, I mean, how much leverage you've got, what should we expect as we see revenue—

Roger Shannon: I do feel like we have good leverage in the model. We've shown that over the past. We've talked about the compression in our gross margins over the course of this past year being revenue and volume related. We expect to be able to enhance gross margins as revenues increase. And then, we have consistently displayed leverage at the operating income level. We've taken strong steps over the course of 2018 to right-size the business, to make it more flexible to the project nature, and we do see leverage at the operating income level as the business expands.

Rod Hall: Great. Okay, Roger, appreciate it.

Roger Shannon: Thank you.

Rod Hall: Out of time, so thanks for coming. Really great to see you, and look forward to continue the conversation.

Roger Shannon: Always a fantastic conference. I appreciate being here.