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EDITED TRANSCRIPT

ADTN - Q1 2015 ADTRAN Inc Earnings Call

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OVERVIEW:

ADTN reported 1Q15 revenues of \$142.8m and GAAP EPS of \$0.06, assuming dilution. Expects 2Q15 revenues to be up mid-to-high single-digit percentages sequentially.



APRIL 22, 2015 / 2:30PM, ADTN - Q1 2015 ADTRAN Inc Earnings Call

CORPORATE PARTICIPANTS

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Mike Foliano *ADTRAN, Inc. - Interim CFO, Treasurer, Secretary, and SVP Operations*

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Rich Valera *Needham & Company - Analyst*

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. And welcome to ADTRAN's first-quarter 2015 earnings release conference call. (Operator Instructions)

During the course of the conference call, ADTRAN representatives expect to make forward-looking statements, which reflect management's best judgment based on factors currently known. However, these statements involve risks and uncertainties, including the successful development and market acceptance of core products, the degree of competition in the market for such products, the product and channel mix, component costs, manufacturing efficiencies, and other risks detailed in our annual report on Form 10-K for the year ended December 31, 2014. These risks and uncertainties could cause actual results to differ materially from those in the forward-looking statements which may be made during the call.

It is now my pleasure to turn the call over to Mr. Tom Stanton, Chief Executive Officer of ADTRAN. Sir, please go ahead.

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

Thank you, Kevin. Good morning, everyone. Thank you for joining us for our first-quarter 2015 conference call. With me this morning is Mike Foliano, our Senior Vice President and Interim Chief Financial Officer. I would like to begin this morning by discussing the details behind our Q1 results and I will end with some comments on what we see for the future.

As stated in our press release, revenues for the quarter were \$143 million, lower than our expectation for the quarter, predominantly due to a sharper-than-expected decline in the euro versus the dollar. And secondarily due to the cancellation of our Tier 1 program here in the US.

Total carrier networks division revenues, including both international and domestic, came in at \$116 million. Total enterprise revenues were \$26.8 million. Revenues from our domestic markets came in at \$83.5 million or 58% of the total. International revenues came in at \$59.4 million for the quarter or 42% of the total revenue.



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On a product basis, our core product areas, which include broadband access, internetworking, and optical, came in at \$131.5 million, essentially flat to the \$131.3 million for the same period last year. More specifically, total broadband access revenues came in at \$84.8 million, up from \$81.5 million for the same period last year.

The increase was driven by growth in our European business and the combined -- excuse me, the continued growth in the Tier 2 market space here in the US as well as solid growth in our fiber-to-the-premises business.

Our internetworking product category came in at \$34.2 million, basically in line with our expectations, as we saw the expected slowness in the CLEC market. Our optical product category came in at \$12.5 million compared to \$12.8 million for the same period last year and HDSL revenue came in at \$6.7 million.

As I previously mentioned, total international sales came in at \$59.4 million, up 9.3% from the previous year, as we saw the seasonal resumption of our vectoring rollout in Europe. In the US market, we did see an expected pickup in the Tier 2 space, driven by market share gains coinciding with CAF-related infrastructure rollouts. However, sales of the Tier 1 market were negatively impacted by the cancellation of the Tier 1 opportunity in the Southeast and other markets that I previously mentioned.

Although we in ADTRAN had completely satisfied the lab requirements and were scheduled to enter first field application and had received initial purchase orders, our program was halted as budgeting issues forced a revaluation and a redefinition of that program. Needless to say, this is a substantial disappointment to our Company and to many of you on the call today. We will continue to work with this carrier as we move forward with other projects of smaller scope that are set to be delivered later this year.

Our enterprise division experienced relatively soft demand in our regional carrier distribution channels and VAR channels that were partially offset by improvement in large carrier channel sales.

Now to move on to what we see for the rest of the year. We expect a Tier 2 US market to continue to build momentum as carriers accelerate their rollouts associated with CAF 1 funds and start their planning and deployments with CAF 2 funding.

Additionally, recent wins for [GIGA] deployments with various Tier 2 and nontraditional carriers will help that segment of the market. That, combined with the incrementally positive movements we expect to see in the Tier 1 space, lead us to believe the US will see solid growth for the year.

We entered this year expecting solid growth in Europe as well and although the demand expectations have not changed on a euro basis, we believe growth on a dollar basis will be substantially challenged by a weakening euro as we progress through the year. In light of that, we will be moderating our expense outlook for this year with an expectation that operating income will improve meaningfully in the second half.

I would now like Mike Foliano to review our results for the first quarter 2015 and provide comments for the second quarter view as well. We will then open the call up for questions. Mike?

Mike Foliano - ADTRAN, Inc. - Interim CFO, Treasurer, Secretary, and SVP Operations

Thanks, Tom. Revenue for the first quarter was \$142.8 million compared to \$147.0 million in Q1 of 2014. This was substantially impacted by a decline in the euro-dollar exchange rate compared to the same period last year.

Broadband access product revenues for Q1 2015 were \$84.8 million compared to \$81.5 million for Q1 2014. Internetworking product revenues for Q1 2015 were \$34.2 million compared to \$36.9 million for Q1 2014.

Optical product revenues for Q1 2015 were \$12.5 million compared to \$12.8 million in Q1 2014. Carrier systems revenues for Q1 2015 were \$100.4 million compared to \$99.6 million for Q1 2014. Business networking revenues for Q1 2015 were \$35.4 million compared to \$37.9 million for Q1 2014.



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Loop access revenues for Q1 2015 were \$7 million even compared to \$9.5 million for Q1 2014. HDSL product revenues for Q1 2015 were \$6.7 million compared to \$8.9 million in Q1 2014. As a result of the above, carrier networks division revenues for Q1 2015 were \$116.0 million compared to \$118.2 million for Q1 2014.

Enterprise networks division revenues for Q1 2015 were \$26.8 million compared to \$28.8 million for Q1 2014. International revenues in Q1 2015 were \$59.4 million compared to \$54.3 million for Q1 2014. To provide the reporting of each of these categories, we have published them on our investor relations web page at adtran.com.

Gross margin was 45.9% for Q1 2015 compared to 52.9% for Q1 2014 and 47.6% for Q1 -- or Q4 2014. The decline in gross margin for the quarter compared to Q1 2014 and Q4 2014 was primarily driven by an increased percentage of international revenues at a weaker euro compared to the US dollar.

Total operating expenses were \$63.6 million for Q1 2015 compared to \$66.5 million for Q1 2014 and \$64.5 million for Q4 2014. The decrease in operating expenses compared to Q1 2014 was attributable to lower selling, marketing, and SG&A expenses. The decrease in operating expenses compared to Q4 2014 was attributable to a deduction in R&D, selling, and marketing expenses.

Acquisition-related amortizations totaled \$0.6 million for the quarter. Stock-based compensation expense, net of tax, was \$1.5 million for Q1 2015 compared to \$1.8 million for Q1 2014. Supplemental information for acquisition-related expenses, amortizations, and adjustments in connection with our most recent acquisitions are provided in our operating results disclosure.

All other income, net of interest expense for Q1 2015, was \$3.5 million compared to \$3.4 million for Q1 2014 and \$4.4 million for Q4 of 2014. Other income for Q4 2014 included a \$2.4 million gain related to the settlement of working capital items for an acquisition transaction that closed in 2012.

The Company's income tax provision for Q1 2015 was at a rate of 39.80% compared to a tax provision rate of 34.55% for Q1 2014 and a net tax benefit of 11.21% in Q4 2014. The tax provision increase on a sequential quarter basis in Q1 2015 was attributable to the expiration of the US R&D tax credit. The tax provision increase year over year in Q1 was due to the release of a valuation allowance that was attributable to a foreign subsidiary in 2014.

Earnings per share on a GAAP basis, assuming dilution for Q1 2015, were \$0.06 compared to \$0.17 for Q1 2014. Non-GAAP earnings per share for Q1 2015 were \$0.10 compared to \$0.21 for Q1 2014.

Non-GAAP earnings per share exclude the effect of acquisition-related expenses, amortizations, and adjustments related to acquisitions and stock compensation expense. The reconciliation between GAAP earnings per share, diluted, and non-GAAP earnings per share is provided in our operating results disclosure.

Inventories were \$93.1 million at quarter end compared to \$86.7 million in Q4 of 2014. Net trade accounts receivable were \$90.9 million at quarter end, resulting in 57 DSOs compared to 63 DSOs at the end of Q1 2014 and 55 DSOs at the end of Q4 2014.

Unrestricted cash and marketable securities, net of debt, totaled \$354.4 million at quarter end after paying \$4.8 million in dividends and repurchasing 141,000 common shares for \$3 million.

The book-and-ship nature of our business, the timing of revenues associated with large projects and the variability of order patterns of our customer base, and the fluctuation in exchange rates may cause material differences between our expectations and actual results. However, our current expectations are that Q2 revenues will be up mid to high single-digit percentages on a sequential basis.

Taking into account euro exchange rates and anticipated mix, we expect that gross margins will be in the low to mid 40%. We expect GAAP operating expenses for the second quarter will be flat on a sequential basis and we expect to see reductions in operating expenses in the latter half of the year. We anticipate a consolidated tax rate for Q2 to be in the high 30% percentage point range for pre-tax income.

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We believe the larger factors impacting the revenue and earnings realized in 2015 will be the following: the macro spending environment for carriers and enterprises; currency exchange rate movements; the variability of mix and revenue associated with project rollouts; professional services activity levels, both domestic and international; timing of revenue related to the Connect America project; and adoption rate of our broadband access platforms and inventory fluctuations in our distribution channels.

Tom?

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

Thank you, Mike. Kevin, at this point, we are ready to open up for any questions they may have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Doug Clark, Goldman Sachs.

Doug Clark - Goldman Sachs - Analyst

First, I want to get a little bit more detail on the US Tier 1 opportunity. AT&T has talked about CapEx coming down now and has guided for that for 2015. So I'm wondering what happened incrementally over the past two months since the last time you reiterated the timing that led to the cancellation of the project.

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

Sure. And to be honest with you, I don't know if I know all of the answers, because we know what we've been told. But -- so as we entered this quarter, we were feeling fairly -- very confident, because we had actually received some initial orders that were getting started with the FFA.

The FFA, which is first field application, was scheduled for kind of middle of the first quarter. And there would be a relatively quick rollout after that. So needless to say, our confidence was fairly high. The FFA was scheduled based off of the software that we currently -- that we had had been working through the labs, so we could work through all of the issues and we're feeling very good.

And then -- now I will tell you that this project is being front-ended or sold through a partner. And during the quarter, it became clear that -- and we're looking at the budgets for the year. This program had come under pressure and under some scrutiny.

And basically, we were told towards, let's say, mid to late in the quarter that the program was not going to move forward. I don't know if that helps you any or not, but that's -- I also have to be a little careful about it. But basically, that's what happened.

Doug Clark - Goldman Sachs - Analyst

Okay. That is helpful. And then looking at the second-quarter revenue guidance, kind of up mid-single digits is pretty well below normal seasonality. And even factoring in some FX -- incremental FX headwinds, the European business alone, looking at last year, seasonality was up pretty meaningfully.

Does that imply kind of an under -- or below seasonal US domestic business for the second quarter? Why are we getting to ultimately well below seasonality for the second quarter?

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Tom Stanton - ADTRAN, Inc. - Chairman & CEO

Yes so, I think if you look -- first of all, I think the FX impact from Q1 to Q2 may be larger in our perspective than yours. Now needless to say, we're not through the quarter yet, so we don't know what the total impact is going to be. But I'll tell you a model, as it still being -- substantially depressed on a sequential basis. And that is, without a doubt, the biggest impact that we are forecasting versus seasonality.

In the US, the Tier 1 budgets that are material got set a little late, so we are probably being a little bit conservative there. But in general, I would say it's what you are seeing versus seasonality is by far predominantly FX-related.

Does that answer your question?

Doug Clark - Goldman Sachs - Analyst

Yes. Thank you. And then if I can, just one more on the gross margin front, similarly related. Certainly, some of it is explainable by FX, but it does appear that the domestic broadband business gross margin have continued to trend lower. Is there any visibility into a possible reversal or explanation of the gross margin pressure?

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

I'm going to go back again, although it may be that your math on what the exchange rate is and our math is different. I've said that in the past that the US business is kind of in the, let's say, 50% to low 50%. And that's basically what we have been -- that's what we experienced in Q1.

That's basically what we are planning on experiencing in Q2. It may be down 50 basis points because of a higher service-related content associated with CAF 1 rollout, so we do a lot of turnkey installs there. But I will tell you, it's still in the same range. The impact we're really seeing is predominantly with our European business.

Doug Clark - Goldman Sachs - Analyst

Okay, thanks.

Operator

Simon Leopold, Raymond James.

Simon Leopold - Raymond James & Associates, Inc. - Analyst

Great, thank you very much. A couple things I wanted to clarify. First, just a housekeeping question. If we could get any color you might be able to offer on 10% customers in the quarter. How many, how big, domestic versus international?

Mike Foliano - ADTRAN, Inc. - Interim CFO, Treasurer, Secretary, and SVP Operations

We had two 10% customers and one was domestic and one international.



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Simon Leopold - *Raymond James & Associates, Inc. - Analyst*

Great. And I wanted to go back on this canceled project. I was a little bit confused by a comment you made about it being reassigned. I think I heard you correctly. I wasn't quite sure I understood the status of what the customer plans on doing at this point.

In other words, I presume they will still upgrade that legacy footprint and it simply is going to go to one of your competitors, but that timing is uncertain. I want to make sure I understand the outlook for that particular activity.

Tom Stanton - *ADTRAN, Inc. - Chairman & CEO*

Sure. And I have to be careful about speaking for that customer, but I really said redefined, not redesigned. And really, I think the net of it is, at least from my perspective, is there were basically timing -- the timing of the substantial rollout may have changed from our expectation or from what the initial expectations were, which allowed kind of a relook at the product set.

So we had a very unique product set. It's not a product set that couldn't be some form or fashion -- let's say functionality-wise duplicated. But we had a product ready to go.

So I think when you go and relook at budgets and relook at priorities, sometimes things slip out. And when things slip out, they'd allow you to do -- they allow you to change your sourcing plans and I think that's what happened here.

I don't know directly what the plans are, but I do know that we were moving forward on the basis that this upgrade had to happen. Although we were moving forward on the basis of it had to happen, it had to happen quick. The quick may have changed, but my sense is it still has to happen. So if that helps you.

Simon Leopold - *Raymond James & Associates, Inc. - Analyst*

Yes, no, that is helpful. So in the past, you've talked about this particular customer as presenting an opportunity worth more than \$200 million. And I understand that's beyond the Southeast regional upgrade project. So what's your assessment today, and maybe more specifically, what's the impact to your 2015 expectations based on this update?

Tom Stanton - *ADTRAN, Inc. - Chairman & CEO*

Yes, that's a good question. I tried to address that in my notes. So I'm not going to try to forecast the revenue of what very well could be a competitor's project at this point. I would like you to ask them that.

But you are totally right that we thought that over several years, that this would be in the neighborhood of, let's say, in the excess of \$200 million. And because of that, we were feeling very strong about the year. And we were feeling also very strong about the euro, because of the imbalance -- I'm sure we talked about this on previous calls -- because of the rising US margin profile, which doesn't also have the FX issue associated with it would be substantially positive for the Company.

At this point in re-forecasting based off of that project being gone, we are in the US looking at growth. And I called it solid growth in my notes. Solid growth to me is, let's say, mid -to high single digits. And if things go positive, then we may be in the low teens. That's what our forecast looks like right now in the US.

So I would still expect growth out of the US this year, but the challenging part is we're going also have a European business, I would say, challenging. I guess it is better than not. But a European business that is growing kind of in the similar profile, if not slightly stronger, with a stronger euro negative bias on margins.



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Simon Leopold - *Raymond James & Associates, Inc. - Analyst*

Great. And then just one last thing I would like to get your thoughts on is I picked up the idea of a concept of a white box GPON platform. In other words, an unbranded GPON.

And that kind of confused me. I'm wondering if you could talk about your perspective of this kind of white box trend coming into your equipment categories. Thanks.

Tom Stanton - *ADTRAN, Inc. - Chairman & CEO*

Yes, sure. And I think it's a -- first of all, I think you're talking about a long-term evolution of the network. And there are some carriers that -- let's say, less than a handful of carriers that have adopted that approach and then others that haven't. Although I do think that logically, it makes sense and you would be correct in assuming that we are definitely at the front edge of that. And in fact, working with very large carriers on what the definition of that will be.

So the thought is to actually simplify -- I will say it, line card designs. And move more things into functional pieces that may be aggregated somewhere else in the network. Architecturally, I think it makes sense.

When you talk about a central office and the functionality in the central office, I think there's an awful lot of opportunity for us there. But I do think it's a really long-term vision that it would be probably -- it would definitely be premature for me to really elaborate on here because it's not something that's going to affect us in the next couple of years.

Simon Leopold - *Raymond James & Associates, Inc. - Analyst*

Thank you for taking my questions.

Operator

Rich Valera, Needham and Company.

Rich Valera - *Needham & Company - Analyst*

Tom, in the past, you've talked about two separate programs with the US Tier 1. One, the regional one, which sounds like it's gone. And there was second one that was kind of national, where you said you had to compete for that one. Can you address the status of that program?

Tom Stanton - *ADTRAN, Inc. - Chairman & CEO*

Yes, Mike, you know -- I would say it's effectively gone. I have not been officially notified, but based off of the progress on the first project, which really allowed the opportunity for the second project to happen, so we would have to exit the FFA piece. And with that not moving forward at this point in time, I would say it's effectively gone.

I did mention -- and I don't want to overstate this, but I did mention that we have other programs with this carrier that are Ethernet-related and access-related, but they are substantially smaller in scope. And right now, they are on track to start shipping kind of initial shipments toward the very tail end of this year. I'm not going to speak a lot about them until they come to fruition, for obvious reasons, but that's really where our opportunity sets lies with this carrier at this point in time.



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Rich Valera - *Needham & Company - Analyst*

Great. And you've, I think as recently as your last call, said that you expected another solid year with DT on the vectoring opportunity. I think you actually said you expected growth this year.

I'm wondering if you could readdress that comment. And then if you could give us any thoughts on that program as you head into 2016. Do you think that that program has another sort of year roughly comparable to this year? And how much runway does that program have? Thanks.

Tom Stanton - *ADTRAN, Inc. - Chairman & CEO*

Yes, I would expect 2016 at this point, without giving you specific guidance. Our view right now on that point is that it will -- it definitely continues on to 2016. If you look at where they are in their footprint expansion and their, by the way, take rate on the services, it's very strong. So I would feel good about that.

We also have -- we have won a couple of other awards within that carrier. One of them is very meaningful for some enterprise gear that actually starts ticking up in 2016 as well. So I would expect positive contribution on a euro basis.

And I will tell you on a euro basis this year, that business -- I think I may have already mentioned it -- will grow meaningfully this year on a year-over-year basis. But I will tell you the euro has substantial impact on that. And so I think some of that will be how does the euro end up looking for the second half of the year.

Our internal forecast and what we are modeling right at this point time shows the negative bias on the euro and that we are expecting continued pressure. I hope that turns out to be a conservative view, but that's what we are modeling.

Rich Valera - *Needham & Company - Analyst*

Great. And I just wanted to clarify your comments. Those growth comments that you had given for both the US and then the European piece, was that specifically broadband access or your overall business?

Tom Stanton - *ADTRAN, Inc. - Chairman & CEO*

Overall business.

Rich Valera - *Needham & Company - Analyst*

Because if you look at the first half, given what you've reported in the 2Q guidance, it would seem like you would need significantly better-than-historic seasonality in the second half to even approach sort of flat for the year for 2015. So just trying to understand --

Tom Stanton - *ADTRAN, Inc. - Chairman & CEO*

Okay, yes. Let me -- when I say overall business, let me make sure. So I would expect the US to be up on a dollar basis, of course, through the year. I would not say that about the -- let me just blanket the international business for the year.

So I think there will be pressure on the international side. The US will grow; the international business and definitely in Europe will grow on a euro basis. But I would not expect growth there on a dollar basis. And that will probably pressure the Europe -- the total Company growth rate for the year.



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Rich Valera - *Needham & Company - Analyst*

So without putting words in your mouth, it doesn't sound like you are expecting overall revenue growth for the year on a dollar basis. Is that fair?

Tom Stanton - *ADTRAN, Inc. - Chairman & CEO*

That's fair.

Rich Valera - *Needham & Company - Analyst*

Thank you. Those are my questions. Thanks.

Operator

Tim Quillin, Stephens.

Tim Quillin - *Stephens Inc. - Analyst*

Tom, could you, as specifically as possible, talk about the timing of the cancellation of the Tier 1 opportunity? And if there were -- I know it had been a technical challenge over the past couple years, and you had, as you said, a unique product set.

But at the end, were there technical issues that pushed the customer towards maybe a simpler design than what you offered?

Tom Stanton - *ADTRAN, Inc. - Chairman & CEO*

I don't believe so. So timing is -- on a timely perspective, there were conversations that went on through the quarter. And in fact, there are still conversations going on now. And what I'm doing is giving you my perspective -- what I think is a relatively educated perspective on how things have turned out and will turn out.

On the technical perspective, we had had issues -- when you going to the lab, and I think I addressed on the last call, we have had issues on software, but I would say not undue issues that you typically find in the lab. And some of those issues were -- are -- some of those issues were the partner that we had.

We had cleaned up predominantly. By that, I mean it was a lab exit kind of software in the fourth quarter. Let's say kind of mid-ish fourth quarter. And really saw no other big issues that came up and our software was ready to exit and going to FFA with that same software load very early in Q1. So I'm not -- I feel comfortable that we had met our mark there.

As far as simplicity of the design, I don't -- I'm not aware that -- and in fact, I would be surprised if -- the way we're doing it is I think the right way to do it. So I don't think that there was a simpler design and simpler way to have it implemented.

I do think that a two-step model is difficult for a carrier like this. And I think that that probably was some of the pressure that we saw. And I think in redefining the program, that allowed them to relook at the whole business model associated with it.

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Tim Quillin - *Stephens Inc. - Analyst*

Right, okay, thank you. And then could you discuss your turf vendor work I think you are doing for a couple different providers? But is that progressing as you hoped it would? Is that turning out to be business that you like? Are you pursuing other opportunities of that type?

Tom Stanton - *ADTRAN, Inc. - Chairman & CEO*

Yes, so the answer is yes. Q1 on the services side of our business met our numbers. Q2 will actually be stronger and you will actually see that accelerate through this year and probably -- we have several different customers. Some are involved in CAF; receiving CAF funding as we speak. And some are scheduled to receive CAF funding later on this year.

And in, I would say the predominant piece of that business, we will be doing services-related work. So on an operating income perspective, it's doing what we expected it to do. It's definitely accretive from where we are right now and we are happy with that business.

We are -- also we have stepped up our services and kind of call it turnkey install, but there's engineering and there's installation of our equipment as well in Latin America. And that seems to be going well and that business will be picking up as well this year.

Tim Quillin - *Stephens Inc. - Analyst*

And then just one last question. Maybe you just can confirm or discuss whether Jim Matthews's departure had anything to do with the weakness in the quarter. And give us an update on your search for a new CFO.

And one of the things that Jim had done a fairly amazing job with is generating investment gains or a high return on your cash and investment income on the balance sheet. And I'm wondering if there will be a change in philosophy, both with regards to how you manage that portfolio cash and investments, but also whether you might consider a more rapid return of capital to investors. Thank you.

Tom Stanton - *ADTRAN, Inc. - Chairman & CEO*

Yes. So let me address the first question and just be as emphatic as I can be. It did not have to do with the quarter. There --without speaking for Jim. I think many of you on the call probably have talked to Jim. There were family reasons why he departed when he departed and that was the totality of it. There was nothing else behind there.

Our investment philosophy hasn't changed. We have a treasurer that pretty much runs that part of the business and nothing has changed there at all. So we will continue to operate it the same way we have operated it.

From a cash to the shareholder perspective, our cash position continued to grow this quarter. And we have in the past and continue to believe that it is our duty to return excess cash to the shareholder and that has predominantly been in a share buyback scenario. We look at that every quarter and I see really no change. And in fact, based off of current performance, that's definitely well within the range by which we would view it to be kind of a positive from a shareholder perspective.

Tim Quillin - *Stephens Inc. - Analyst*

And then update us on the timing of your CFO search? Thank you.



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Tom Stanton - ADTRAN, Inc. - Chairman & CEO

Oh, I'm sorry. So we have quite a few candidates that have expressed interest. We are in the midst of an interview process. We have seen some. We will see some more.

And you know how searches go in kind of really landing somebody and getting them in the job. But my sense is we will have somebody in the position -- our recruiting firm is going to shoot me for this, but my sense is we will have somebody positioned by the next time we get on the phone call. At least, that would be my hope.

Tim Quillin - Stephens Inc. - Analyst

All right, thank you very much.

Operator

Rod Hall, JPMorgan.

Rod Hall - JPMorgan Chase - Analyst

I guess I just wanted to circle back on the OpEx flexibility. I know Mike, you said that it sounds like revenue growth is going to be flat. You guys are saying that earnings or operating profit should be up, implying you will reduce OpEx. I think that's kind of what you meant by the commentary.

Could you give us any idea how much you might be able to reduce or what your flexibility there is, just so we can think about the full year OpEx might look like?

And then I also -- I know the Tier 1 thing has kind of beaten to death, but I wanted to come back and just make sure I understand what your confidence level, Tom, is, that the business has been awarded someone else? Or do you think that it's -- can you give some sort of a -- how confident you are in that?

And if you are pretty confident, do you think it was a technology issue? Do you think -- what is it that caused the change? But I'm mostly just interested in your confidence level.

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

Okay. My confidence is very high. To be honest with you, I would not bring it up if my confidence wasn't somewhat high there. It's not something that I relish in talking about. So it is very high. I do not see a change in that. People do change their mind, but I think that their mind -- they have stated where they are going.

As far as the technology or whatever, I don't think there were any technology issues. We had gotten where we needed to be in the process based off of this schedule of the project. So I'm not aware of any technology issues that would have kept -- but that wasn't the reason.

Rod Hall - JPMorgan Chase - Analyst

The reason I asked that, we see it in other projects. They continue to move toward end-to-end integration and choosing vendors as a result that sort of thinking. And I'm just wondering did that potentially drive their thinking here? As we are aware some stuff they're doing on the business access, business access systems automation side of things and also in optical that are moving toward automation.



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Tom Stanton - ADTRAN, Inc. - Chairman & CEO

Yes. I've seen the equipment that that -- well, I shouldn't say I've seen it, because I haven't physically seen it. But I know which equipment that is competitively being used for this. And there is really -- there's not -- it's not a better technology solution the one that we had proposed.

And I don't -- I think the net is there is an incumbent there that is very strong, that I think saw a hole in what is probably a very good growth business for them. That was not just a Southeast hole, but that it was a nationwide hole. And I think they were very aggressive.

And I think that we had a two-step model that was -- had its own issues associated with it when you try to go in there against an incumbent who really, really does not want to lose the business. So I think at the end of the day, that that model definitely didn't help us in this situation.

Rod Hall - JPMorgan Chase - Analyst

Yes. And then -- okay, thanks for that. The OpEx. Can you guys comment at all [against] any idea?

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

Yes. If you will, I would like to put that off until our next conference call. We gave you a general color. We expect it definitely in the second half. We have shown our ability to be able to do that in the past when we come under pressure. This is the first time where we've really had kind of a FX-driven pressure.

And -- but we've dealt with it before and we'll deal with it now. So we do have plans that are firming up and some that have already been literally executed on as we speak. But I would like to be able to give you more color when I can do it in a more concrete way, which would be on the next call.

Rod Hall - JPMorgan Chase - Analyst

Okay. But you guys are definitely saying earnings are up this year year over year, while revenues are roughly flat.

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

I don't know if we said that, because -- so I don't know that we're saying that. I said that we would see a significant increase in the second half versus the first half of this year. But that's all we were trying to imply at this point.

Rod Hall - JPMorgan Chase - Analyst

Okay. Great, thank you, Tom.

Operator

Amitabh Passi, UBS.

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Amitabh Passi - UBS - Analyst

Tom, I guess I wanted to touch on the enterprise business for a bit. I think we've seen now five quarters of declining sales. I just wanted to understand, do you think there's now structural elements that are putting pressure on that business? Or what else is impacting the sales outlook within your enterprise business?

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

Yes, I think there -- well, there are two things. One is if I look at the enterprise business on a product segment basis, the weight is on the IP gateway piece. And in fact, routers typically do good. They did good this quarter. They were actually up. Switches come and go. They are slightly up or slightly down.

But IP gateways drive the predominant piece of that business. That's number one. And number two, there was an ONT component to that business. If you go back, I think roughly year ago, Mike, I'm not sure if you have in front of you, but that has been migrating over to the carrier side of the business.

If I look specifically on IP gateways, which is what's driving -- what's drive that numbers up and down, literally -- if I look at the quarter, there was no market share loss compared to any period of time. And specifically -- specific areas of weakness were with the CLECs.

And that's really where that weakness has been centered for some time. If I look at the CLEC market -- let me call it competitive carrier market, so a little bit broader than just CLEC. Maybe that's the same term, but non-independent or non-RBOC market is probably the right way to look at it.

And if I look at that, no major technological shifts. There are some carriers that are going through mergers. There are quite a few of those carriers that are going through management changes. And in almost all cases, we're seeing a slowdown from their business side.

If I try to reach fundamentally, are they losing market share? They are definitely -- the numbers are down. So needless to say, in looking at that, and you're right, it's been a few quarters now, we are looking at that in a complete product segment and saying what do we need to do. We have introduced some products that we think will bolster and augment that, including our SBC product line, which started shipping last year. But that is one of those things that we are reviewing at this point.

Amitabh Passi - UBS - Analyst

And just as a follow-up, you spoke about the Tier 2 outlook in the US. I didn't hear you say much about Tier 3s, unless I missed that. Just wanted to get your thoughts around Tier 3 spending trends, particularly in North America.

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

So I didn't talk much about Tier 3s because to be honest with you, the aggregate of the Tier 2 business is so big that it kind of swamps the Tier 3s at this point. And there's so much going on with the different phases of CAF funding -- of course, some of those Tier 2s also have done recent acquisitions of carrier properties, which we think are positive towards us because in most of these carriers, we have, by far, predominant market share.

Tier 3s, I would say, are kind of -- at least in the quarter, were, I will call them flattish. It didn't see a whole lot. The CAF funding rules or the USF to CAF funding rules are getting clearer, but it's going to be dominated -- I would expect maybe some growth this year. But the real story is going to be in the Tier 2 space.



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Amitabh Passi - UBS - Analyst

Got it. And just one final one, if I may. I think you guided to low to mid 40% gross margin for the second calendar quarter. To the extent that the US does a little better in the back half, would you expect gross margin to continue to trend up from those levels as we look at the back half of the year?

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

I'm going to speak for Mike and then he can shoot me. I would think yes, and that's for two reasons. One, yes, the US business will be up -- should be up in the second half. And the seasonal pattern of our European customer is that it really peaks around Q2 and then Q3, it goes down a little and then Q4, it goes down. So the European content will be less as well.

Amitabh Passi - UBS - Analyst

Okay, thank you.

Operator

Paul Silverstein, Cowen.

Greg McNiff - Cowen and Company - Analyst

Thank you. This is Greg McNiff for Paul. Thanks for taking my question. Two questions. Just on the Tier 1 cancellation, do you think other customers -- other DSL vectoring customers may be at risk, given the lack of certification?

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

Lack of certification. Well, no. The Tier 1 -- let me be clear about this. The Tier 1 in the US is a specific customer that had single-sourced their entire access network and was looking for a second source and was looking for a technology solution. We got all the way through to where we were entering the field, then it was stopped. It has -- there's no bearing on any other customer that we have.

Greg McNiff - Cowen and Company - Analyst

Got it, thank you. And then on the NetVanta business, to what extent would DT have to contribute there to see some sort of turnaround or improvement?

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

I am not dependent on DT in order to see improvement on there. As I just mentioned -- well, NetVanta. So we don't report a NetVanta number. My guess is -- I'm going to look at Mike here.

Yes, my guess is the NetVanta number is actually doing well and it is probably up. The products that are -- now. It is also true, I believe. I don't know if that's a NetVanta or Total Access product for --.



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Mike Foliano - ADTRAN, Inc. - Interim CFO, Treasurer, Secretary, and SVP Operations

NetVanta 4660.

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

So it will actually just be accretive to it. And we had mentioned previously that that was the single largest enterprise win that they have ever had. And it really starts -- and I think I've been very open about this, that really starts shipping from their forecast perspective strongly in 2016.

Mike Foliano - ADTRAN, Inc. - Interim CFO, Treasurer, Secretary, and SVP Operations

Yes, there's some 2015 shipments, but it's fairly small and the big ramp happens next year.

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

And this customer seems to be very good at forecasting their numbers. So it will lift the NetVanta number, but the left -- NetVanta number today I don't think is depressed. I think the majority of the pressure is on our total access IP gateway line.

Greg McNiff - Cowen and Company - Analyst

Got it, thank you very much.

Operator

George Notter, Jefferies.

George Notter - Jefferies & Co. - Analyst

I wanted to ask about the plan for OpEx reductions later in the year. Have you guys -- I guess my impression on ADTRAN is that the Company historically has been pretty efficient in terms of how it spends its dollars on sales and marketing and R&D.

And I guess I'm just trying to get a better sense for where you guys might have an opportunity to cut costs. Is it possible that you guys will look at a portfolio review, where you would look at the lines of business that you're in? It seems like this level of R&D -- \$61 million, \$62 million a quarter -- I should say in OpEx per quarter. It kind of feels like you are funding a lot of different product areas there. Is that something you look to do is to trim the portfolio a bit?

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

Yes, but I will tell you that's not a new concept. We do periodically do that. But yes, we're looking at every area where we can reduce costs. And we look at [what] commitments and we look at the return on those commitments. And yes, needless to say, there will be a lot of scrutiny on that and that's an ongoing process right now.

George Notter - Jefferies & Co. - Analyst

Got it, okay. And then I also wanted to ask about deferred revenue. I assume the declines sequentially on deferred revenue have been a function of the CAF funding in the projects and how those projects move to formal revenue acceptance.



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Is that the case? And then also, would you expect that deferred revenue would start to bottom in terms of those declines as the CAF business runs off?

Mike Foliano - ADTRAN, Inc. - Interim CFO, Treasurer, Secretary, and SVP Operations

George, this is Mike. That's exactly right. That comes from large projects that require additional work to complete. The reduction happened in CAF as well as some of that came from a large project in Mexico that some of that has completed. But I also believe there will be new pieces moving into there, along with the pieces moving out. So I don't expect that it will bottom out.

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

So you don't expect that they were at a bottom -- excuse me, you expect it to go up.

Mike Foliano - ADTRAN, Inc. - Interim CFO, Treasurer, Secretary, and SVP Operations

Right.

George Notter - Jefferies & Co. - Analyst

Got it, okay. And then somebody asked about investment gains or other income I think earlier in the call. My understanding is that there has been a historical ownership of dialog semiconductor stock here in the investment portfolio.

And I think if I remember it correctly, there was a period of time where you guys were selling some component of that stock position on a quarterly basis to drive some of those numbers in the other income line. Is that now through the model or how much more of that is there left here to monetize?

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

George, we really don't talk about the individual investment pieces in the portfolio. So I don't have that in front of me, anyways. But I will just say our philosophy on our investment really hasn't changed.

George Notter - Jefferies & Co. - Analyst

Okay. So directionally, those kinds of run rates in that other income line ought to be consistent going forward. Is that fair?

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

I think that's fair, depending on what the market is. And there is also, on the other income line, there are offsets that will come in from time to time based off of any type of hedging we do on the euro. So I think there's fluctuations there.

George Notter - Jefferies & Co. - Analyst

Got it, okay. Great, thanks very much.



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Operator

Sanjiv Wadhvani, Stifel.

Sanjiv Wadhvani - Stifel Nicolaus - Analyst

Two questions on my side. One, just to confirm. It looks as if Q2 might be the bottom in gross margins and then second half, because of US ramping up and Europe sort of ramping down, you should see gross margins heading higher. I just wanted to confirm that.

And then second, Tom, for you, just wanted to get some clarity on your comments around the fact that the Tier 1 solution was a two-step process. I was wondering if you could just elaborate on that a little bit? And I was wondering if pricing played any role in any decisions over there? Thanks.

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

Sure. Mike, if you -- the answer to your question on gross margins is yes. So we expect Tier -- second quarter to be the bottom? The two-step process that I was talking about is we actually were selling to a partner, who was then selling it to AT&T. That partner themselves had a required margin in order for them to flow it through their business and I have no doubt that that had an impact.

Sanjiv Wadhvani - Stifel Nicolaus - Analyst

Got it. All right, that's helpful. Thanks.

Operator

Michael Genovese, MKM Partners.

Michael Genovese - MKM Partners - Analyst

I just wanted to understand the assumption about 2Q gross margins a little bit more. I guess you are assuming in that a similar level of depreciation in 2Q as what we saw in 1Q for the euro? Is that the right assumption that you're making?

Mike Foliano - ADTRAN, Inc. - Interim CFO, Treasurer, Secretary, and SVP Operations

Our assumption shows that it will continue to fall. I think we're hearing a lot from the big banks and the guys that track this that they expect parity potentially by the end of the year. So we're trying to take some of that thinking and model it out as we go.

Michael Genovese - MKM Partners - Analyst

Okay. So basically, how dependent is the gross margins in the back half of the year to -- whether this keeps happening are not or whether we kind of finish this and maybe get to parity or get to where we're going by the middle of the year? So can you say with certainty that gross margins have hit the bottom in 2Q? And is that really dependent on what else currency does in the back half of the year?



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Tom Stanton - ADTRAN, Inc. - Chairman & CEO

Well, we have a model for Q2. That's already baked into the numbers that we have. And so yes, if it were to take a substantial decline from what our current thinking is, it could impact it. But we are trudging our way through Q2 as we speak and we think we've covered the base there. So we think we're fairly -- we are conservative enough in that number to feel good about it.

In the second half, if the euro were to fall below parity, it would impact us. The positive piece that we have in the second half of the year is that the European portion of that business also declines because of the project nature. So the US will have more of an impact, which across the board is higher gross margins.

Michael Genovese - MKM Partners - Analyst

Okay. And then on the OpEx, I just want to make sure I'm not missing anything that you're saying. So I hear you saying that there is room to cut OpEx in the back half of the year, but I just want to make sure I didn't miss any kind of quantitative goalposts around that on what the size of that reduction could potentially be?

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

No, you didn't miss any. I will talk about it more extensively on the next call. What we're trying to do is directionally let you know what we were thinking about OpEx and we will have more detail. But leave it to say that we do expect operating margins to substantially improve from the first half levels.

Michael Genovese - MKM Partners - Analyst

Okay. And then finally, also to be clear on what you're saying as opposed to what analysts on the call are saying, I heard this discussion of flat revenues for the year. And I couldn't figure out whether that was guidance or not or just a discussion point that came up in the Q&A. What is your take on this flat revenue level for the year?

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

That's a good point, because we typically don't guide out a quarter. And I would not try to tell you that I have any surety about what's going to happen in the fourth quarter of this year.

But I would say in answer to a question, that that's kind of the way that we are seeing the business at this point, which is up in the US. And then international is being substantially pressured by the exchange rate.

Michael Genovese - MKM Partners - Analyst

Got it. Okay, thanks, Tom.

Tom Stanton - ADTRAN, Inc. - Chairman & CEO

Okay, that this point, I guess we have no more questions. So I appreciate you joining us on the call and we look forward to a positive call in the second quarter this year. Thank you very much.



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Operator

This does conclude today's teleconference. You may now disconnect. Thank you and have a great day.

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