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EDITED TRANSCRIPT

ADTN - Q3 2015 ADTRAN Inc Earnings Call

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OVERVIEW:

ADTN reported 3Q15 revenues of \$158.1m and GAAP EPS, assuming dilution, of \$0.14.



CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

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Rich Valera *Needham & Company - Analyst*

Doug Clark *Goldman Sachs - Analyst*

Simon Leopold *Raymond James - Analyst*

Tejas Venkatesh *UBS - Analyst*

George Notter *Jefferies - Analyst*

Tim Quillin *Stephens - Analyst*

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Bill Dezellem *Tieton Capital Management - Analyst*

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to ADTRAN's third-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 cost, manufacturing efficiencies, currency exchange rate fluctuations and other risks detailed in our annual report on Form 10-K for the year ended December 31, 2014 and Form 10-Q for the quarter ended June 30, 2015. 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 of the Board and CEO*

Thank you, Kevin. Good morning, everyone. Thank you for joining us for our third-quarter 2015 conference call.

With me this morning is Mike Foliano, Senior Vice President and interim Chief Financial Officer. I'd like to begin this morning by discussing the details behind our Q3 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 \$158.1 million with slightly lower than expected international sales, being predominantly offset by a very strong performance in the US. Our total Carrier Networks Division revenues, including both international and domestic markets, came in at \$131.3 million. Total Enterprise Network revenues came in at \$26.8 million. Revenues from our domestic market came in at \$119.5 million or 76% of the total, and international revenues came in at \$38.6 million for the quarter or 24% of the total.

The strong regional shift in sales was predominantly due to growing momentum in the US broadband market and a slightly stronger than normal seasonal decline in Europe. Carrier sales here in the US were up 35% over the same period last year and over 16% sequentially. The growth in this



area came from increased sales in both Tier 1 and Tier 2 accounts. On a product basis, our core product areas, which include broadband access, inner networking and optical, came in largely as expected at \$146 million.

More specifically, total broadband access revenues came in at \$94.1 million with solid performances in both our GPON and fiber-to-the-node product areas. In North America we saw strong performance in gigabit GPON shipments and a very strong performance in vectoring VDSL2 shipments and CAF-related VDSL shipments.

Our inner networking product category came in at \$38.1 million, up 15% from Q2 as this area benefited from previously mentioned GPON strength and a nice sequential improvement on nearly all our enterprise products as sales through our service provider channels saw some improvement. Our optical product category came in at \$13.7 million.

On a geographic basis, as I mentioned, total international sales came to \$38.6 million with EMEA sequentially down and Latin America sequentially up. Gross margin and OpEx came in as expected as we saw meaningful improvements in both compared to the previous quarter.

Moving forward into 2016, we expect the positive momentum we have seen associated with CAF builds to grow as ADTRAN customers who in total have accepted \$9 billion in CAFII funding begin deployment. This, along with incremental spending associated with PUC commitments, a general increase in carrier competition and recently received Tier 1 lab approvals should bode well for the products and services associated with this area and the US market in general.

Additionally we continue to progress our efforts in securing additional Tier 1 market share both here and abroad as most Tier 1 carriers around the world begin addressing competitive and economic factors and accelerate deployment plans using GPON, next-generation PON, G.fast and vectoring.

I'd now like Mike Foliano to review our results for the third quarter of 2015 and provide comments on the fourth quarter to you as well. We'll then open the conference up for questions.

Mike?

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

Thanks, Tom. Revenue for the third quarter was \$158.1 million compared to \$162.9 million for Q3 2014 and \$160.1 million for Q2 2015. Broadband access product revenues for Q3 2015 were \$94.1 million compared to \$96.1 million for Q3 2014 and \$100.7 million for Q2 2015.

Inner networking product revenues for Q3 2015 were \$38.1 million compared to \$38.6 million for Q3 2014 and \$33.2 million for Q2 2015. Optical product revenues for Q3 2015 were \$13.7 million compared to \$13.7 million for Q3 2014 and \$16.4 million for Q2 2015. Carrier systems revenues for Q3 2015 were \$111 million compared to \$114 million for Q3 2014 and \$119 million for Q2 2015.

Business networking revenues for Q3 2015 were \$39.1 million compared to \$39.7 million for Q3 2014 and \$34.2 million for Q2 2015. Loop access revenues for Q3 2015 were \$7.9 million compared to \$9.2 million for Q3 2014 and \$6.9 million for Q2 2015. HDSL product revenues for Q3 2015 were \$7.4 million compared to \$8.4 million for Q3 2014 and \$6.4 million for Q2 2015.

Carrier Networks Division revenues for Q3 2015 were \$131.3 million compared to \$133.0 million for Q3 2014 and \$135.4 million for Q2 2015. Enterprise Networks Division revenues for Q3 2015 were \$26.8 million compared to \$29.9 million for Q3 2014 and \$24.7 million for Q2 2015. International revenues for Q3 2015 were \$38.6 million compared to \$64.3 million for Q3 2014 and \$55.7 million for Q2 2015. The year-over-year reduction includes the effects of the decline in the euro dollar exchange rate, and the quarter-over-quarter reduction is primarily driven by seasonality factors.

To provide the reporting of each of these categories, we published them on our Investor Relations webpage at adtran.com.



Gross margin for the quarter was 44.7% compared to 48.0% for Q3 2014 and up from 42.6% for Q2 2015. The decline in gross margin for the quarter compared to Q3 2014 was primarily driven by the change in the euro dollar exchange rate, and the improvement in gross margin compared to Q2 2015 was primarily driven by the regional revenue and product mix shifts.

Total operating expenses were \$62.6 million for Q3 2015 and \$61.7 million for the same quarter net of nonrecurring charges compared to \$65.8 million for Q3 2014 and \$67.6 million for Q2 2015. The decrease in operating expenses compared to Q3 2014 and Q2 2015 is attributable to structural changes and ongoing expense controls. Acquisition related amortizations totaled \$0.4 million for the quarter. Stock-based compensation net of tax was \$1.5 million for Q3 2015 compared to \$1.8 million for Q3 2014. Supplemental information for nonrecurring charges, acquisition-related expenses, amortizations, and adjustments in connection with the most recent acquisitions and our stock-based compensation expense are provided in our operating results disclosure. All other income, net of interest expense for Q3 2015 was \$2.8 million compared to \$2.6 million for Q3 2014 and \$3.5 million for Q2 2015.

The Company's income tax provision for Q3 2015 was at 35% compared to a tax provision rate of 24.8% for Q3 2014 and a tax provision rate of 38.12% for Q2 of 2015. Earnings-per-share on a GAAP basis, assuming dilution for Q3 2015, were \$0.14 compared to \$0.21 for Q3 2014 and \$0.05 for Q2 2015. Non-GAAP earnings-per-share for Q3 2015 were \$0.19 compared to \$0.25 for Q3 2014 and \$0.10 for Q2 2015. Non-GAAP earnings-per-share exclude the effect of nonrecurring charges that are designed to reduce our operating expense rate, 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 \$100.7 million at quarter end compared to \$100 million even in Q2 2015. Net trade accounts receivable were \$86.2 million at quarter end, resulting in 50 DSOs as compared to 57 DSOs at the end of Q3 2014 and 51 DSOs at the end of Q2 2015. Unrestricted cash and marketable securities net of debt totaled \$283.4 million at quarter end after paying \$4.5 million in dividends and repurchasing 1,020,773 common shares for \$16.5 million.

The book and ship nature of our business, the timing of revenues associated with large projects and the variability of order patterns of the customer base into which we sell, along with fluctuation in currency exchange rates, may cause material differences between our expectations and actual results. However, our current expectations are that due to the near-term slowness in our European business we expect that revenues in Q4 will be slightly below our historical seasonal pattern of a 12% sequential quarter reduction as some of our scheduled European shipments have been pushed into Q1 of 2016.

Taking into account exchange and anticipated mix, we expect that our gross margins will be slightly below Q3 levels. We expect that operating expenses for the fourth quarter will be down from our Q3 expense level, and we anticipate a consolidated tax rate for Q4 to be in the high 30s percentage point range for pretax income. 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 related -- of revenue related to Connect America Fund projects, and the adoption of our broadband access platforms and inventory fluctuations in our distribution channels.

With that, I'll turn it back over to Tom.

Tom Stanton - ADTRAN, Inc. - Chairman of the Board and CEO

All right. Thanks, Mike. Kevin, at this point, we are ready to open it up for any questions people may have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Rod Hall, JPMorgan.



Rod Hall - JPMorgan - Analyst

I guess I've got two questions for you. One is, could you comment on -- we get that Europe is weak. Can you comment on trends in Latin America and what you're seeing there and what you are expecting in Q4? You know, kind of what's built into the guidance.

And then I guess bigger picture, just what are you guys thinking for growth next year? I know you are not going to want to give us quantitative guidance, but what is your level optimism that things continue to pick up, and we are seeing a little bit of a sign of life in the access side of things. So just curious kind of generally what you're thinking the direction of that access market might be next year. Thanks.

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

Alright. So let me cover the last piece first. So the US business has been down for -- down, declining and then flat for 3.5 years. There's been very little capital spending going on in the US, and we started seeing a pickup, CAF-related pickup, earlier towards the tail end of last year, and without a doubt, that continued to do well, and we've seen that pickup kind of broaden, and we are expecting CAFII to come into full force next year, which would -- without a doubt -- every single carrier that has received CAFII we have been in talks with about what their plans are, and we expect the US to do well next year.

The European market is -- we saw -- the issue with Europe for the quarter and really for the fourth quarter is it's got more to -- it has nothing to do with that project. If you follow the European customer base and specifically our large European customer, you'll see that they are doing very well with customer adds. They have very ambitious plans. They are at this point trying to roll out some -- excuse me -- greater than 100 Meg services to a very large percentage of their footprint. They are less than 15% through that process right now of the total customers that they serve, and they have announced plans to start rolling out super vectoring after they get vectoring rolled out.

So we feel good about the long-term prospects and even 2016 on that. The issue that we have right now is that they just really have more inventory than they can install between now and the end of the year, so they've asked us to hold back on shipments until they can catch up. So I don't see any long-term disruption there, but without a doubt it's a disruption for the fourth quarter.

Latin America specifically, we had a pretty good quarter this quarter, substantially up from second quarter. I would expect it probably to be seasonally down in the third quarter. There is talk about them coming in with another order, although I would expect that to be kind of first quarter-ish. So and we do still have a lot of services work with them. So a lot of the timing of the revenue associated with them is how quickly we can install and revert -- and well basically install and turn up equipment. There is still a lot of inventory. There is inventory out in the field right now that we are trying to get installed, but the net to your question is they had a pretty strong third quarter. We expect fourth quarter to be down.

Rod Hall - JPMorgan - Analyst

Tom, and LatAm next year? What do you think for next year?

Tom Stanton - ADTRAN, Inc. - Chairman of the Board and CEO

Next year -- so we have a couple of things going on. One, they have given us initial thoughts on vectoring on it. They will do more vectoring next year than this year, and there's also some additional awards which we haven't really discussed about in the PON area that will be beneficial. But my sense would be, though, right now is the way I would model them is flattish to this year.

Rod Hall - JPMorgan - Analyst

Okay. Thank you.



Operator

Rich Valera, Needham & Company.

Rich Valera - *Needham & Company - Analyst*

Tom, I was wondering if you'd be willing to give any additional color on a vectoring program which was discussed last quarter with CenturyLink. I think they are doing a trial in Salt Lake to see how that technology affects their competitive positions. Just wondering if you've got any updates there as to how it might relate to your opportunity?

Tom Stanton - *ADTRAN, Inc. - Chairman of the Board and CEO*

Yes, I'm going to shy away from being very specific on customer things. They have announced what they were doing. Everybody knows we are a big piece of that. Let me see what I can -- my sense is we're doing very well with that customer, and I don't want to announce their plans but I know of no issues. Can I stop at that?

Rich Valera - *Needham & Company - Analyst*

That's helpful. And then, looking into next year, wondering if you would be willing to give any color as to how you think gross margins for the year might look versus 2015. And likewise, for modeling expenses next year, should we use that sequentially down run rate in 4Q for the quarterly OpEx since we would take that into next year? How should we think about expense levels for next year?.

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

Yes, we've been fairly specific on our target there. We are trying to get to 5% below the Q1 run rate by the exit of Q4 this year. We are well on track to do that. So I think the Q4 number will actually be higher than our Q1 number. And if you think about that I think we said mid-single digits down, which is roughly 5%, is where we expect our Q1 numbers to be. They were not -- at this point we feel we are very much staffed properly. Let me put it this way. We don't need to add any additional staff. So I would say that that's a good baseline, and it may move up just because of revenues moving up or down but in sales expense associated with that. But not -- we're not expecting any big variations from that really through the year.

As far as gross margins, without a doubt, US will be stronger next year, and US typically has a margin -- a higher-margin profile. So we would expect margins to improve in aggregate next year versus this year, and that's been our thoughts for a while now. That still hasn't changed. If anything, that's probably gotten a little bit stronger because of we've got more visibility as to where the CAF spending is going to be.

Rich Valera - *Needham & Company - Analyst*

Great. That's helpful. Thanks, Tom.

Operator

Doug Clark, Goldman Sachs.

Doug Clark - *Goldman Sachs - Analyst*

Maybe a follow-up on that gross margin point and more specifically for the fourth quarter. Assuming that the geographic mix remains kind of US-heavy in the fourth quarter, kind of what is driving the sequential decline in gross margins?

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

It's a little messier. So one is, of course, we have lower revenue, which is -- which will impact that. The other is on the lower revenue, there is still a relatively high percentage service piece to that number, and because the number is lower, that percentage of revenue will be higher. So that's impacting it as well.

So I would call it probably more mix than anything else. Though I will tell you we had a very good services quarter this quarter as well, and without a doubt, it was accretive to operating income. But that's really what the question was.

Doug Clark - *Goldman Sachs - Analyst*

Okay. Thanks. Then separate question, you mentioned during the prepared remarks that there was Tier 1 lab trial approvals that you are currently working on. Is that a current customer or a current large customer, or is that a largely new greenfield opportunity?

Tom Stanton - *ADTRAN, Inc. - Chairman of the Board and CEO*

It's a greenfield opportunity. It's one I've talked about before with a very large carrier in the US where although they decided to halt one program they were continuing on with another program, and that was supposed to exit at this time. It did exit the lab. We are into field trials now, and we expect to be deploying in Q1 next year. There is, of course, other RFPs that I think people are aware of going on with that carrier as well.

Doug Clark - *Goldman Sachs - Analyst*

And can you talk at all about expectations for kind of materiality or revenue contributions?

Tom Stanton - *ADTRAN, Inc. - Chairman of the Board and CEO*

It's not as big as the other one. So I would view it in the tens of millions.

Doug Clark - *Goldman Sachs - Analyst*

All right. Thank you very much.

Operator

Simon Leopold, Raymond James.

Simon Leopold - *Raymond James - Analyst*

First, want to see if we could maybe get a little bit of color on a housekeeping issue around 10% customers. I know you don't like to disclose all that much detail, but if we could get some idea of how many if any and sort of the nature domestic versus international.



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

Simon, this is Mike. We had two 10% customers in the quarter, and both of them were in our domestic business.

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

And in terms of the guidance you've offered us suggesting more than a 12% sequential decline and sort of the reference to what's going on in Europe, I guess I'm a little bit puzzled because it seems as if you had such a sharp decline in September that sequentially you would have an easy comparison. Maybe it would help if I had a better understanding of the linearity of that European demand during September. Is it something where the quarter maybe started out okay and fell off later in the quarter, and so that continues into December? Can you help us think about it because it's already at a low base in September. Does that question make sense?

Tom Stanton - ADTRAN, Inc. - Chairman of the Board and CEO

Yes. It does make sense. So there are two things that are impacting us in Europe, and I would ask you to go back to the extent you keep notes on the different conference calls. I think we've explained some of it early on.

One is, they had a stronger than anticipated -- I wouldn't say anticipated. They came out and told us first half was going to be stronger. Q1 was strong. Way stronger than typical and Q2 was very strong. So they really bought a lot of equipment with the intention of really trying to accelerate their build, and they expected the second half to be weaker and we had, I think, voiced that. And the net of it, though, although they bought an awful lot of equipment in the first half, they just didn't get it installed, and so now they are sitting there. They have an accelerated plan that for whatever reason and my sense would be it's probably man powers related. They couldn't get all of the equipped installed, and now they are really basically, I'll say for all intents and purposes, shutting off the spigot for Q4.

Now we actually have orders in hand that were scheduled for Q4, and they have just asked us to move them into Q1.

Simon Leopold - Raymond James - Analyst

Okay. So with this guidance, it does imply that Q1 seasonality might be sort of a bit of a reversion to the mean and maybe better than historical given everything you know today.

Tom Stanton - ADTRAN, Inc. - Chairman of the Board and CEO

That is -- I think there are two positive impacts. One is now let me -- the answer to your question is yes, but let me give you more information, which is not necessarily positive or negative. One is they had a really strong Q1 last year. I don't know based off of what happened this year and their inability to do that if it will be a strong in Europe as it was Q1 of -- next year as it was this year. So, but from a quarter -- sequential quarter to quarter, without a doubt it will be -- without a doubt. We already have orders in-house that are bigger than what we would expect for Q1 and what we would expect to ship in Q4.

(multiple speakers) One other thing, Simon, is our view of the US market is we would -- is definitely stronger than we would typically see in Q1 as well.



Simon Leopold - *Raymond James - Analyst*

And maybe that's related to my last question here. How do you think the CAFII funds play out in terms of timing? Have you seen any showing up yet? What's your expectation for the way those funds show up in other December or the March quarters? How do you -- what's the pattern you are anticipating?

Tom Stanton - *ADTRAN, Inc. - Chairman of the Board and CEO*

So, on CAFII specifically, we have seen let me say small orders for CAFII. Nothing earth shattering, but they have -- one carrier has started with CAFII, but we would expect a real rollout to start next year. They won't all jump on, so I'll temper what I just told you before. But they won't all jump on in Q1. We don't expect that. We do see some CAFII orders, though, shipping in Q1, and we've already, like I said, started receiving orders for that.

Simon Leopold - *Raymond James - Analyst*

Great. Thank you for taking my questions.

Operator

Amitabh Passi, UBS. Amitabh Passi, please check the mute function on your phone.

Tejas Venkatesh - *UBS - Analyst*

Sorry about that. I'm Tejas here on behalf of Amitabh. I just had a couple of quick questions. How should we think about the US business declines in 4Q relative to the overall 12% decline?

Tom Stanton - *ADTRAN, Inc. - Chairman of the Board and CEO*

The bigger decline is in Europe.

Tejas Venkatesh - *UBS - Analyst*

Okay. And could you also speak to the sequential rebound in enterprise sales? What's the source, and is it sustainable going forward?

Tom Stanton - *ADTRAN, Inc. - Chairman of the Board and CEO*

Good question on sustainability because one quarter doesn't make a trend. It was good to see that after -- we had talked before about what the -- about the carrier channel -- the carrier channels. We have two carrier channels. We call them CSPs and NSPs, large carriers and CLECs, and both of those channels were up. And the good thing is it was a fairly broad-based step-up. I mean switches were up. Routers were up. IP gateways were up. So it looked good. Point-of-sale out looked good, but it was one quarter. So we knew that there was some inventory correction that was going on that we had previously talked about. Maybe that could be easing up some. I can't be definitive about that, but it was one quarter. So we'll just have to see.

Right now our kind of view of the fourth quarter is to have a fairly decent fourth quarter in the enterprise segment. Right now, pipeline looks good, but we will have to wait and see.



Tejas Venkatesh - UBS - Analyst

And lastly, are you seeing any pause in vector DSL deployments ahead of G.fast? I was curious how the G.fast trials are going.

Tom Stanton - ADTRAN, Inc. - Chairman of the Board and CEO

G.fast trials are going very well. At least, the bigger ones are going very well. And the answer to that question is no. So there are really two different things. So if you look at the range of G.fast, it's incredibly short. So, it's really focused on the MDU market segment, not the SFU, not the single-family home. So they are kind of two different things, and MDU market, of course, is fairly big. It's affecting some carriers. It's very large. But if you look at the RFPs that are out right now, they are all centered around MDU deployment. So, I view those as two separate animals really.

Tejas Venkatesh - UBS - Analyst

Okay. Thank you.

Operator

George Notter, Jefferies.

George Notter - Jefferies - Analyst

I wanted to ask about the CAFII funding and your opportunity there. I guess one of the opening questions there is just how much of that business is really incremental? I guess it assumes that the operators are able to scale up from a professional services perspective and do more work in aggregate. Can you kind of -- any new perspectives there on how easily those guys can scale up and how much of the business is really incremental to what you would otherwise get?

Tom Stanton - ADTRAN, Inc. - Chairman of the Board and CEO

I know that is a real question mark that people have. Look, let me try to tackle it kind of by class of carrier. So we have some carriers that as you probably know have been very aggressive with CAF Phase I, and our revenue with them is up dramatically. I mean, very much meaningful. Without a doubt, if I look at incremental being are they spending more than what they did in any year in the last three years and is that meaningfully more, the answer is absolutely positively yes.

Now, the way that some carriers are tackling this is they are using -- I would say almost all of them that have a meaningful CAF spend, including the largest that have a meaningful CAF spend, they are looking to augment their internal service organizations with other organizations, and you've seen that increase in probably some of the other companies that you follow that are much more outside plan and service related. So they have been -- their plans are to augment -- in general, their plans are to augment their organizations with outside help, and in some cases and in our case specifically, we are doing some of that work ourselves, which has been why the services piece has grown.

George Notter - Jefferies - Analyst

Got it. Thanks.

Operator

Tim Quillin, Stephens.



Tim Quillin - *Stephens - Analyst*

Thank you for taking my question. I just want to clarify the fourth-quarter guidance a little bit. So I understand that revenue will be below seasonally normal down 12%. Is it in that ballpark? Is it slightly below that level or meaningfully below that level?

Likewise on gross margins, I think you said below Q3. Is it substantially below Q3 or just a little bit?

And then I think, Tom, you mentioned something about OpEx maybe being down 5%. I know your target is down 5% from 1Q, but I don't know if that 5% was 3Q versus 4Q versus 3Q or what precisely you are referring to. Thanks.

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

Let's start with your seasonality question. If you go back and take a look at your models and you see that, that 12% is really looking at the timeframe of since we have had the large European business. Because we've talked multiple times here about how that business is much more front-half loaded. So if you go back and do your modeling based on 2012, 2013 and 2014, you come up with roughly that 12%, and our guidance was around that we would be slightly below that. So (multiple speakers)

Tom Stanton - *ADTRAN, Inc. - Chairman of the Board and CEO*

Slight is the answer in the first place, and on gross margin same thing. Slightly. We are not talking a major shift in gross margin.

And then your last question was --?

Tim Quillin - *Stephens - Analyst*

OpEx.

Tom Stanton - *ADTRAN, Inc. - Chairman of the Board and CEO*

OpEx. So if you think about 5% below Q1 as being the target exiting the quarter and you kind of use a ruler to get there from where we are right now, that's probably a good way to think about it.

Tim Quillin - *Stephens - Analyst*

Okay. Got it. And then the last question is around your international pipeline. If you could just give some color about the opportunities you are seeing around the world and if you have any update on opportunities you might have in Australia. Thank you.

Tom Stanton - *ADTRAN, Inc. - Chairman of the Board and CEO*

I wish I did. So in Australia -- so, look, first of all, there's opportunities in Europe. Some are bigger than others, and one is very large in Europe, which is still an ongoing process. I think we are literally meeting with them daily right now, so they are still going through -- that's not -- that's a carrier that has, let's say, a complicated decision process. So it's a fairly long process, but that's still moving forward. We are still in the trials with them, and we'll just -- we don't have an answer on that and unfortunately the same thing with Australia. Australia has been going through this process for some period of time. They -- I think we are looking very well, but we haven't won anything.



It's been complicated to be kind a little bit by the fact that the government just changed. So and that's -- that has ramifications on timing within the carrier that we are trying to do business with there. But I think that will work itself out relatively quickly, but hopefully we'll see an answer this quarter.

Tim Quillin - *Stephens - Analyst*

Great. Thank you.

Operator

Greg Mesniaeff, Drexel Hamilton.

Greg Mesniaeff - *Drexel Hamilton*

Just a quick question on products. Tom, can you give us an update on what kind of product refreshes you have planned for next year, particularly against the backdrop of the CAF ramp? Thanks.

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

Sure. So and, in fact, I will make a note of that to maybe do a better job of conveying product development in our next conference call. So let me step back a little bit and say from a macro level what we are looking at.

First of all, G.fast is the technology that everybody is interested in right now, and we have some carriers that are moving. So we have multiple developments in the G.fast area. Not necessarily CAF-related, but in the G.fast area. Predominantly in Tier 1 carriers is where the biggest interest is.

In PON we announced maybe a quarter ago, our 10-gig PON system, which was XGS-PON, and we have substantially this year broadened our OMT segment. We feel we are in good position there. Going forward into next year, I think if you talk to carriers, people will tell you we have the best SDN and virtualized access story of any carrier of any vendor out there. There is interest in that, but that's not a 2016 thing. In fact, if that was 2018, I would be happy. But it does help us pull through equipment that we are actually selling today, and it gives carriers a migration path to where they want to go to into the future.

Specifically for CAF, we have -- that predominantly hits our 1100 fiber-to-the-node area. We have some long reach versions of that product which have really started shipping I'm thinking middle of this year. We started introducing those products which were specifically geared for long reach kind of low population density, kind of what the CAF model is. But they won't all be that. There are quite a few that are cabinet-based. If I look at CAFI, we probably did more cabinet-based than kind of sealed low-cost base solutions. But I think you'll see a mix of those going forward, and those will typically be VDSL products that just hit the price point that people need to hit.

Greg Mesniaeff - *Drexel Hamilton*

Got it. Thanks. That's very helpful.

Operator

Paul Silverstein, Cowen.



Unidentified Participant

This is [Han] in for Paul. Can you remind us -- you had won this enterprise business through Deutsche Telekom selling into the enterprise segment, selling the NetVanta product line. How does that affect your outlook given what you just -- given your commentary around Europe?

Tom Stanton - ADTRAN, Inc. - Chairman of the Board and CEO

It will be for next year. So the outlook -- it doesn't affect this year's outlook. For next year, it's without a doubt a positive, and we really haven't tried to forecast Europe for next year. At this point, when we get through this quarter and it's really kind of towards the end of this quarter, we get a better look at what their plans are. They share with us kind of more what they assume their staffing plans are, and the B&G award, which is what you are talking about, will be incremental to whatever that is.

Unidentified Participant

And how do we look at the gross margin for those channel sales? Are they relatively better than your sales through to your other products that you are selling into Deutsche Telekom?

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

I would rather not get into that. I would rather not try to share our price points. But let me see if I can give you -- my -- let me put it this way. It won't move the needle one way or the other. Maybe that's being too specific, but it's -- I don't see it in 2016. It will move the revenue needle. I don't see it moving the gross margin needle, if that helps you.

Now, we will see gross margin improvement next year just because some of the cost reductions that we are doing, but basically it won't move the needle. The real gross margin story for next year is going to be an incremental increase in US sales.

Unidentified Participant

Got it. Thank you so much.

Operator

(Operator Instructions). Bill Dezellem, Tieton Capital.

Bill Dezellem - Tieton Capital Management - Analyst

Thank you. I'd like to circle back to the CAF funding and ask, when you look at the total CAF spending on an annual basis that you are anticipating, how does that size relative to past cycles that you have been through?

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

If I use the current CAFI spend as a model, which was predominantly one carrier, I mean it's by far the biggest thing we've seen. And if I look at the plans that people have at this point in time, it's -- we haven't seen -- it is substantially bigger than broadband stimulus, which was the last thing that we saw, though, it's just bigger. I mean it's substantially more dollars and more long-lasting.

Bill Dezellem - *Tieton Capital Management - Analyst*

And are we understanding correctly that broadband spending really that was the last time when your revenues hit the high level?

Tom Stanton - *ADTRAN, Inc. - Chairman of the Board and CEO*

Right. There was good and bad of that. The bad was that it pulled forward some capital, and we hit a trough that was exacerbated by that pull forward. The fact that this one is a six-year program and doesn't even include the CAFII for the smaller carriers, yes, I think it's a different animal, and the answer to your question is yes.

Bill Dezellem - *Tieton Capital Management - Analyst*

Okay. So to be super super specific, 2011, that's when your revenues and earnings peak as a result of that spending. And you are -- from what you see right now, the CAFII spending will be able to take your business to a higher level than what you achieved at that point.

Tom Stanton - *ADTRAN, Inc. - Chairman of the Board and CEO*

That's our expectation.

Bill Dezellem - *Tieton Capital Management - Analyst*

Great. Thank you.

Tom Stanton - *ADTRAN, Inc. - Chairman of the Board and CEO*

Okay. Okay at this point, I think we are ready to close up. So I appreciate everybody for joining us on the conference call, and we look forward to talking to you next time.

Operator

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

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