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ADTN - Q4 2015 ADTRAN Inc Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by and welcome to ADTRAN's fourth-quarter 2015 earnings release conference call.

All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer period. (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 and Form 10-Q for the quarter ended September 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. Please go ahead, sir.

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

Thank you Dawn. Good morning everyone. Thank you for joining us for our fourth-quarter 2015 conference call. With me this morning is Roger Shannon, Senior Vice President and Chief Financial Officer.

I'd like to begin this morning by discussing the details behind our Q4 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 \$139 million, slightly higher than expected driven by strong performance here in the US. Our total carrier networks division revenues, including both international and domestic markets, came in at \$116.7 million. Total enterprise networks revenues came in at \$22.3 million. Revenues from our domestic markets came in at \$112 million, or 81% of the total. International revenues came in at \$27 million for the quarter, or 19% of the total.

The strong regional shift in sales was predominantly due to growing momentum in the US broadband market, and the slightly stronger than normal seasonal decline in Europe.



Carrier sales here in the US were up 37% over the same period last year, and down a less than seasonal 4% sequentially. The year-over-year 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, internetworking and optical, came in largely is expected at \$129.1 million. More specifically, total broadband access revenues came in at \$84.9 million with solid performances across most of the US product areas and continuing momentum in our service group.

In North America, we continue to see a solid performance in gigabit GPON shipments and a very strong performance in Vectoring/VDSL2 shipments and CAF related VDSL shipments. Our internetworking product category came in at \$30.3 million, down 15% from Q4 of 2013 as a pickup in Tier 1 sales was not able to overcome continuing slowness in IP gateway sales to the CLEC and MSO market. Gross margin and our OpEx came in better than we expected as we exceeded our operating targets set earlier this year.

Moving to the future and what we see ahead, as many of you on the conference call are aware, the access market in most geographies has been in a cyclical slowdown, which has limited growth in many areas, most notably for us here in the US. That in combination with the challenging currency market made growth in 2015 very difficult. Having said that, there were quite a few accomplishments and movements within our customer base that we believe may be catalysts for change in the future. The USF to CAF transition is one of those catalysts. Over \$3 billion per year is being made available to incentivize broadband buildout in areas that have been economically challenging for carriers to deliver. That when combined with the regulatory commitments to upgrade millions of lines given on the heels of recent acquisitions helps set the stage for a significant investment cycle.

Further amplifying this cycle is the significant upgrade cycle of MSO carriers to DOCSIS 3.1 and PON technologies to substantially increase the availability of gigabit services. Several carriers here in the US and around the world have announced plans to begin initial deployments of these technologies in 2016 with significant accelerations to follow in upcoming years. Needless to say, this cycle will change the definition of acceptable broadband service and significantly change the competitive landscape. And although the timing of the material change may be debated or fluctuate, we believe the landscape is changing. Of course ADTRAN needs to be prepared with the leading edge technologies necessary to benefit from this cycle.

In 2015, ADTRAN announced a trial of the world's first Class G optical products, significantly reducing the cost of deployment for next-generation optical access systems. ADTRAN's Access platforms now support GPON, XGS-PON, NG-PON2 and EPON. In Q1, ADTRAN will be trialing its first 10 gig EPON in various configurations developed to meet the unique requirements of the MSO market. Also in Q1, ADTRAN will be trialing the industry's first virtual OLT system, including both hardware and software, in collaboration with a global Tier 1 carrier.

End-to-end fiber connectivity is the ultimate goal for most carriers. However, due to cost, network architecture and regulatory constraints, copper connectivity remains a reality. Technologies such as bonding, Vectoring, SUPERVECTORING and G.fast allow carriers to deliver over 1 gig utilizing their existing infrastructure. In 2015, ADTRAN began trialing multiple configurations of SUPERVECTORING and G.fast, and we exited the year securing a major award by a Tier 1 carrier here in the US for G.fast. An additional SUPERVECTORING award by a Tier 1 carrier in Europe was also received at the end of last year. We expect both of these to deliver in 2017.

In 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 price cap carrier CAF II funding begin deployment. Current expectations are for rate of return carry rules to be finalized sometime in Q1.

We also expect to see the start of incremental spending associated with the PUC commitments following recent acquisitions. Additionally, we continue to progress in our efforts to secure 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 various forms of vectoring.

I would now like Roger Shannon to review our results for the fourth quarter of 2015 and provide comments on the first-quarter view as well. We will then open the conference up for questions. Roger?

Roger Shannon - ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary

Thank you, Tom, and good morning.

Revenue for ADTRAN's fourth quarter was \$139 million compared to \$144 million for Q4 of 2014 and \$158.1 million for Q3 of 2015. For the full year 2015, revenues were \$600.1 million compared to \$630 million in 2014.



Looking at our core products, broadband access product revenues for Q4 of 2015 were \$84.9 million compared to \$82.5 million for Q4 of 2014 and \$94.1 million for Q3 of 2015. Internetworking product revenues for Q4 2015 were \$30.3 million compared to \$35.7 million for Q4 2014 and \$38.1 million for Q3 of 2015. And optical product revenues for Q4 2015 were \$13.9 million compared to \$13.1 million for Q4 of 2014 and \$13.7 million for Q3 of 2015.

In our legacy products, HDSL product revenues for Q4 2015 were \$4.9 million compared to \$5.8 million for Q4 of 2014 and \$7.4 million for Q3 of this year. Other products were \$5.1 million for Q4 of this year compared to \$6.9 million in Q4 of 2014 and \$4.7 million in Q3 of 2015.

For our product categories, Carrier Systems revenue for Q4 of this year were \$102.9 million compared to \$100.3 million for Q4 of 2014 and \$111 million for Q3 of this year. Business Networking revenues for Q4 of 2015 were \$31 million compared to \$37.3 million for Q4 of 2014, and \$39.1 million for Q3 of 2015. Loop Access revenues for Q4 of 2015 were \$5.2 million compared to \$6.3 million for Q4 of 2014, and \$7.9 million for Q3 of 2015. Carrier Networks division revenues for Q4 of this year were \$116.7 million compared to \$115.8 million for Q4 of last year and \$131.3 million for Q3 of 2015. Enterprise Networks division revenues for Q4 of 2015 were \$22.3 million compared to \$28.2 million for Q4 of 2014, and \$26.8 million for Q3 of this year.

Turning to our geographic mix of revenues, domestic revenues for Q4 2015 were \$112 million, up \$18.9 million from the \$93.1 million in Q4 of last year, but down from \$119.5 million in Q3 of this year. International revenues for Q4 2015 were \$27 million compared to \$50.9 million for Q4 of last year and \$38.6 million for Q3 of 2015. As discussed in prior quarters, the year-over-year reduction includes the effect of significant decline in the euro-dollar exchange rate. The quarter-over-quarter reduction is primarily driven by seasonality factors. We have published the reporting of each of these categories on our Investor Relations webpage at ADTRAN.com.

Our gross margin for the fourth quarter of this year was 44.9%, down from 47.6% for Q4 of 2014, but up from the 44.7% for Q3 of 2015. The decline in our gross margin for the quarter compared to Q4 of 2014 was primarily due to continued weakness in the euro-dollar exchange rate. The improvement in our gross margin this quarter compared to Q3 was primarily driven by regional revenue and product mix shifts.

Total operating expenses were \$59.6 million for Q4 of 2015 compared to \$64.5 million for Q4 of 2014 and \$62.6 million for Q3 of 2015. For comparison purpose, Q3 2015's operating expenses were \$61.7 million net of nonrecurring charges that occurred in that quarter. The decrease in operating expenses compared to both Q4 of 2014 and Q3 of 2015 was attributable to realized savings from previous quarters' structural changes and ongoing expense controls.

Operating income for the quarter just ended was \$2.8 million compared to \$4 million in Q4 of last year and \$8.1 million in Q3.

Looking at our supplemental information, restructuring expenses were \$21,000 in Q4 of 2015 compared to zero in Q4 of 2014 and \$900,000 in Q3 of this year. Acquisition related amortizations totaled \$500,000 for the quarter compared to \$600,000 for Q4 of 2014 and \$400,000 for Q3 of 2015. Stock-based compensation expense net of tax was \$1.7 million for Q4 of 2015 compared to \$2 million for Q4 of 2014 and \$1.5 million for Q3 of 2015. Supplemental information for nonrecurring charges, acquisition related expenses, amortizations and adjustments in connection with the most recent acquisitions and stock-based compensation expense have been provided in our operating results disclosure.

All other income net of interest expense for Q4 2015 was \$2.4 million compared to \$4.4 million for Q4 of 2014 and \$2.8 million for Q3 of 2015.

The Company's tax provision for Q4 2015 was a net benefit of \$503,000 or an effective rate of negative 9.65% compared to a tax provision rate of negative 11.21% for Q4 of 2014 and a tax provision rate of 35% for Q3 of 2015. The net tax benefits in Q4 of 2015 and 2014 were driven by US legislation extending research and development tax credits that passed in the fourth quarter of both years. Going forward, the R&D tax credit has been made permanent.

Net income for Q4 2015 was \$5.7 million compared to \$9.3 million in Q4 of 2014 and \$7.1 million in Q3 of this year. Earnings per share on a GAAP basis, assuming dilution for Q4 2015, were \$0.12 per share compared to \$0.17 per share for Q4 of 2014 and \$0.14 for Q3 of 2015.

The extension of the R&D tax credit in Q4 resulted in a \$0.06 per share earnings per share benefit in the quarter. Non-GAAP earnings per share for Q4 of 2015 were \$0.16 per share compared to \$0.19 for Q4 of 2014 and \$0.19 for Q3 of 2015. Non-GAAP earnings per share exclude the effects of nonrecurring charges incurred to reduce our operating expense rate, acquisition related expenses, amortizations and adjustments and stock compensation expense. The reconciliation between diluted GAAP earnings per share and diluted non-GAAP earnings per share is provided in our operating results disclosure.

Turning to the balance sheet, inventories were \$96.7 million at quarter end, down from \$100.7 million in Q3 of 2015. Net trade Accounts Receivable were \$71.9 million at quarter end, resulting in a reduction in our DSO to 48 days compared to 57 DSOs at the end of Q4 2014 and 50 DSOs at the end of Q3 2015.

Unrestricted cash and marketable securities net of debt totaled \$272.8 million at quarter end 2015 after paying \$4.5 million in dividends and repurchasing 22,600 common shares for \$400,000 during the quarter.



Looking ahead, 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 and the fluctuation in currency exchange rates in international markets we sell into may cause material differences between our expectations and actual results. However, our current expectations are that our Q1 2016 revenues will be flat to slightly up compared to the quarter just completed.

Taking into account currency exchange rates and anticipated mix, we expect that our gross margins will be consistent with Quarter 4's results. We also expect that operating expenses for the first quarter will be consistent with our prior guidance of a \$60 million area run rate, and we anticipate the consolidated tax rate for Q1 to be in the mid to high 30% range with the permanent status of the R&D credits now factored in.

We believe the significant factors impacting the revenue and earnings realized in 2016 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; the timing of revenue related to Connect America Fund projects; the adoption rate of our broadband access platforms; and inventory fluctuations in our distribution channels.

Finally, as mentioned on previous calls, ADTRAN is evaluating the possibility of a change in segment reporting of financial results to better align with the Company's operating strategy going forward. With that, I'll turn the call back over to Tom.

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

Thanks very much, Roger. At this time, Dawn, I think we are ready to open up for any questions they may have.

QUESTION AND ANSWER

Operator

Certainly. (Operator Instructions). Rod Hall, JPMorgan.

Ashwin Kesireddy - JPMorgan - Analyst

Thanks for taking my question. This is Ashwin Kesireddy on behalf of Rod. Tom, could you confirm what's driving the strength in US broadband access now? Other vendors have seen some early CAF II spending from Windstream. Have you seen the same? Also, it appears like a handful of price cut carriers have not yet started CAF II deployments. When do you expect most of them to start deployment under the program? And then I have a question for -- a follow-up question for Roger.

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

Sure. I'm hesitant to talk about specific customers, because sometimes that's problematic for the customer. I'll say we saw some CAF II in orders in Q4. We may have shipped a little bit of that CAF Phase II or CAF II. And that was from -- so we had CAF I and CAF II shipping in Q4 and we would expect more than one carrier to be ordering and probably shipping in Q1 as well. If that helps.

Ashwin Kesireddy - JPMorgan - Analyst

Thanks. And can you give us any more color on what's going on with the rate of region carriers? I understand there were some federal trials towards the end of 2015 (multiple speakers)

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

Go ahead Roger.

Roger Shannon - ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary



That was not on the FCC's calendar at January as some thought that it might be. We think that it's possible that the rules may come down at the February meeting. So hopefully we will know more at the end of the first quarter on the rate of return carriers.

Ashwin Kesireddy - JPMorgan - Analyst

Thanks. One last question. On the international revenue, can you tell us what was international revenue growth or decline in constant currency?

Roger Shannon - ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary

I don't think we have that in front of us. And I'd have to pick the quarters, so on a year-over-year basis, and there still would have been a significant decline, but that's why I don't have that number in front of me right now.

Ashwin Kesireddy - JPMorgan - Analyst

Thanks very much.

Operator

Paul Silverstein, Cowen and Company.

Paul Silverstein - Cowen and Company - Analyst

Thanks. Tom, I appreciate the sensitivity in particular customer disclosure, but is there anything additional you could add on the two new Tier 1s you referenced, the one domestic and the one -- I think you said European?

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

Sure. The European one is -- I can give some color without getting into too much trouble here. So both of them, first of all, let me say we are not expecting shipments until 2017. The carrier in the US is a large carrier that had been going through an RFP process here in the US for a significant portion of 2015. It was finally awarded in Q4. That rollout is for high bit rate services predominantly for MDUs. And it's part of a much broader rollout plan that they have. In Europe, it is about all about the same thing of getting higher connectivity speeds for using SUPERVECTING for residential services. I'm not sure what else I can say about that except, again, here again it's not delivering until 2017.

Paul Silverstein - Cowen and Company - Analyst

Okay. And then one more if I may. Looking at the numbers, it looks like you're -- the investment cases almost flipped, i.e. if we went back in time, following your acquisition of Nokia broadband, that was the big driver and you had growing strength there for quite a while. I don't know if this is a more persistent trend. But looking at the numbers of the last three quarters, while your US business has improved, it looks like the non-US has gone the other way, where it was down 45% year-over-year this quarter. The last two quarters were particularly weak as well. Is there some anomaly? Is this a one-off albeit over three quarters, or looking out over the next year, should we expect this type of weakness in the non-US business? And what's driving it?

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

Yes, so there are two things driving it. If I look for the total year, without a doubt the biggest driver was fluctuations in the currency market. And we've been pretty consistent in pointing it out when that was the case. So you have to haircut that.



If you look at the last three quarters, of course that was exacerbated by the fact that if you look at Q1, it was incredibly strong for our European business. So we had a movement of business from Q4, let's say what would've been Q4 in a normal quarter, that actually occurred in Q1 and that's why we talked about the slide out and a more than seasonal decline in our European business, which we actually did see.

We expect Europe to be stronger in Q1. We expect it to actually pick back up not to the levels that we saw this year, because we expect them to be on a more normalized pattern. If you look at international in general in 2016, the thing is we don't know what the currency is going to do. So if you look at it kind of on a constant currency basis right now, without knowing any better, including Telmex, we are basically saying flattish. So your premise, I agree with you, we had international sales growing while the US was declining. Now we feel much stronger about the US market, which of course is positive on multiple fronts, including the margin level. And in the international market, until we actually bring on some of these awards, which is 2017, we are expecting basically a flat market on a constant currency basis.

Paul Silverstein - Cowen and Company - Analyst

Okay. Just to make sure I heard you right, with respect to the non-US business, for the first quarter, you're expecting it to be up sequentially, albeit less than the first quarter of last year? Is that of 2013?

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

Yes.

Paul Silverstein - Cowen and Company - Analyst

Okay, great. I appreciate it. I'll pass it on.

Operator

Doug Clark, Goldman Sachs.

Doug Clark - Goldman Sachs - Analyst

Hi. Thanks for taking my question. My first one is just a higher level question on particularly North American CapEx. What are your expectations for budget releases and the timing around those in the first quarter embedded within your guidance?

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

We are expecting typically the smaller the carrier, the easier it is for them to release their budget. So we are expecting -- so we are expecting build outs to be planned and start shipping in Q1 for let's say Tier 2 carriers or the smaller Tier 2 carriers. And our expectation is, as is typical, that you would see the larger carriers not really fully release their budgets until the tail end of Q1 and then start seeing more material shipments in Q2.

Doug Clark - Goldman Sachs - Analyst

Okay. That's helpful. And then I appreciate the color on the kind of the two G.fast and SUPERVECTING wins. Is there additional opportunities or RFPs out there that you are also pursuing? And then one just housekeeping item, 10% customers for the full year. Could you give us if there were and to what revenue percentage they were for the year?

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

Sure. As far as the other ones, yes, there are several awards going on. We still have -- we have more trials going on in G.fast to my recollection than any other product we've ever launched. And I think we actually have more trials than any other vendor, by the way, in the industry at this point.



There are several RFPs out there. Several of them are fairly large, including in Europe and in the Pac-Rim area. And they are just progressing. One of them is very, very close to award, I'll say maybe as close as you can get to an award. And there's, again, a finalization of what timing and things would be for whoever that vendor is, and then one of them is still yet to be determined. So, those are the two bigger ones. So I think that answers your question.

As far as the 10% -- go ahead.

Roger Shannon - *ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary*

We had two 10% customers for 2015.

Doug Clark - *Goldman Sachs - Analyst*

Can you give us any detail as to what percentage of revenues they are?

Roger Shannon - *ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary*

That will be disclosed in our 10-K.

Doug Clark - *Goldman Sachs - Analyst*

Okay, got it. Thank you.

Operator

Sanjiv Wadhvani, Stifel.

Sanjiv Wadhvani - *Stifel Nicolaus - Analyst*

Thanks. Tom, just one broad level question. When you look at CAF II, I think there are some debates going on whether it's incremental or substitutive. Just curious to get your thoughts around that.

And then just confirming on the European carrier as far as constant currency, are you expecting that carrier to be kind of flat this year compared to last year, or do you expect it to grow a little bit? Thanks.

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

Okay. So let me take the second one. So on the carrier in Europe, basically what I'm trying to do is be able to give myself a little bit of latitude. There are negotiations still going on as to what the extent of the market share award is that we are going to get this year.

If I look at international in general, we have some puts and takes, and my sense is and our forecast at this point is basically flat on a constant currency basis. So that's kind of where we are.

We have a customer in Latin America that can and often does surprise us with upside. We are not factoring really any that upside into our forecast at this point in time, and just trying to be relatively conservative on that.

And your first question again please?

Sanjiv Wadhvani - *Stifel Nicolaus - Analyst*



Just on CAF II, you had debates on incremental or substitutive, so just trying to get your thoughts around that.

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

That's almost an eye of the beholder type question. So the way that we are looking at it is if I take a look at the spend and the forecasted spend, and in many cases, especially with Tier 2 carriers, we are building plans in conjunction with them. So if I look at the spend that they're spending with us in this realm of CAF II versus what they were spending with us prior to CAF II, without a doubt it is incremental to our revenue. So that's the way we look at it. Now, whether or not their entire capital budget is less or more, to be honest with you, I'm less worried about that, whether or not they buy less routers or do less back-office whatever. I'm okay with that as long as my hope is that in the access space that we are playing in we see an incrementally larger wallet share, and that's the way we look at it and that's what our current forecast reflects.

Sanjiv Wadhvani - Stifel Nicolaus - Analyst

Got it. That's helpful. Thank you.

Operator

Michael Genovese, MKM Partners.

Michael Genovese - MKM Partners - Analyst

Thanks a lot. Tom, first of all, I wanted to just confirm that this rate of return piece of the CAF project that we are expecting to get news on in the current quarter is the same as the Tier 3 program that you're talking about?

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

Yes, yes it is.

Michael Genovese - MKM Partners - Analyst

It's supposed to be \$1.8 billion a year I think. And my question is if we are getting news in the first quarter, do you think that -- are you fairly certain that there will actually be dollars disbursed by the second and third quarters of this year?

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

The way we're looking at it right now is we are not factoring a lot of that into second and third quarter, or for that matter fourth quarter. And the reason is even after the rules have been set, it takes a while for carriers, especially Tier 3s, to digest what those rules are and what that means to their operating business and how much they are actually going to spend.

So although we think anytime if you're incrementally putting in \$1 billion to \$2 billion into a market per year, we do think that there will be a positive impact to that. How those rules come out, how positively they are viewed and how quickly they are accepted are things that right now are just out of our control. So, we are not factoring in a lot of that. We are basically -- we expect the Tier 3 market to be stronger for us this year because in general the market in the US is stronger, but we are not factoring in a big bump this year. We would expect that next year.

Michael Genovese - MKM Partners - Analyst

Fair enough. When you look at a program, whether it's \$1.5 billion or \$3 billion, is there a back of the envelope way that you just look at it and say, hey, maybe 20% of that is our opportunity, or is it really case-by-case and you can't (multiple speakers)



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

It is case-by-case, but the number is big enough to where you think you'd have a lot of averages working on you. And what -- the numbers that we have used in our planning are generally accepted because of the history predominantly with broadband stimulus is somewhere between 10% and 15% would actually fall to the Access Equipment piece. That's going to vary carrier by carrier and architecture by architecture, but that's the general rule of thumb I think that most people use.

Michael Genovese - *MKM Partners - Analyst*

Great. And then last question maybe for Roger. Just specifically for the first quarter, help me more specifically think about the mix between expected -- if we are flat or slightly up and the mix between international, which I'm sure is going to grow, could you help quantify that in any way? But also what are the puts and takes that gross margins come out flat in that wash?

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

I'm going to answer for Roger because I'm putting a hand over his mouth right now, virtually putting a hand. So as far as the international version, we expect international to be stronger. We expect it to be stronger than Q4. It's not going to -- I think we've kind of given just on this call the range of not as high as it was in Q1 of this year. So if you kind of go back historically and take a look at what the international business has done and kind of derive from that, I think you'll get a sense of that.

Really on the US market, the US market is typically seasonally down. The total market, by the way, the total ADTRAN revenue is typically seasonally down mid single digits if I recall. Is that right Roger?

Roger Shannon - *ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary*

That's right.

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

So we would -- we do expect a stronger environment than is typical in Q1, but having said that, we are not at a point to where we want to just kind of unleash it being fantastic. So we are expecting incrementally stronger driven predominantly by, on a sequential basis by growth in the European market. Having said that, that also means that the US market will probably be not as down as it typically has been.

Michael Genovese - *MKM Partners - Analyst*

Okay. And the gross margin piece, how that comes out, flat, just what are the puts and takes on the gross margin?

Roger Shannon - *ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary*

I think the puts and takes are a couple of things. Obviously, the domestic versus the international mix to the extent that there is a larger than expected increase in the international or as Tom just mentioned a higher than seasonally typical mix in the domestic for the first part of the year. Also to the extent that the mix in services changes on the domestic side.

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

I think, if you look on a sequential basis, we had a pretty strong -- I mentioned it in my notes, we had a pretty strong services quarter in the US. So, we would expect a little bit stronger product quarter, not as strong as the services. As people get rolling, you typically miss the first part of the quarter on a services installation basis. So more product in the US, less services in the US, stronger international, and the net of that is basically flat.



Michael Genovese - *MKM Partners - Analyst*

Thanks a lot.

Roger Shannon - *ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary*

To, I want to make one correction to a comment regarding the 10% customers. There were -- for the full year, there were three 10% customers. Again, we will further disclosure on that in the 10-K.

Operator

Rich Valera, Needham & Company.

Rich Valera - *Needham & Company - Analyst*

Thank you. I was wondering if you would be willing to comment on how you view historical seasonality into 2Q. It's a pretty wide range over the last several years, and whether you think you might be above or below that historical seasonality this year, given some of the programs you know that will be ramping as we move into that second quarter.

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

That's a really good question. It is -- look. We expect without a doubt Europe will be stronger. That will drive the international number to be stronger, so we would expect a sequential increase. We definitely expect a sequential increase in the US market. Whether or not it will be seasonally -- we'll talk about that of course on the next call. But in general, we are expecting this year to be better than 2015. So through the year, we would expect it to continue to get better and then we would expect a normal decline in the fourth quarter.

Rich Valera - *Needham & Company - Analyst*

So in terms of that playing out, I'm guessing you don't really want to answer this, but would you expect better than historical seasonality as we move through the year as that sort of momentum picks up?

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

Let's do this. We typically give guidance on a quarterly basis, so I would hate to get that granular. I would say we expect this year to be better than 2015 and kind of leave it at that. And we expect the normal seasonal pattern this year which we will expect growth in Q2. Our new seasonality is kind of Q3 is right around the Q2 level and then you will see a decline in Q4.

Rich Valera - *Needham & Company - Analyst*

Okay.

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

To be honest with you, I don't have a granular enough forecast even if I wanted to to bring that up that I would have faith in. We have a sales forecast, but at this point in time people are still finalizing their budgets. A lot of people want to get CAF done as quickly as possible. Some of them aren't in a position to get it done as quickly as possible, so a lot of that is being worked out right now.



Rich Valera - Needham & Company - Analyst

Got it. And there's been a pretty broadly discussed vectoring program with CenturyLink that they had a trial in a specific city for and are potentially going to ramp that pretty significantly. I don't know if you are able or willing to give any color on that program.

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

They've done a really good job of giving color themselves. I will tell you from our perspective that program is going very well. I think it's doing what they expect to do, but I will have to leave that to you to ask them. But we are very bullish on the potential for that. And it points to a problem that many carriers, if not most carriers, have, which is it is economically viable to deploy to larger urban areas fiber, which is a large percentage of the market, and we are very much focused on that. But at the same time, you still have an awful lot of your network that is just economically challenged in doing something like that. We are now to a point now with the different vectoring technology, G.fast technologies and bonding to where you can truly have a kind of market-leading deployment over copper as well as using fiber. And I think CenturyLink's initiative is a fairly bold initiative in trying to prove that case point out here in the US.

Rich Valera - Needham & Company - Analyst

Great. Thanks for taking my questions.

Operator

George Notter, Jefferies.

George Notter - Jefferies LLC - Analyst

Thanks very much. I guess I'm trying to better understand what longer-term trajectory on gross margins look like. I guess if I look backwards over the last couple of years, you've seen certainly a fair amount of gross margin decline. I guess the question for me is how much looking back is related to FX? How much looking back is related to the growth in the services business? Are there some other organic components to the gross margin erosion? And how do you think about those pieces on a go-forward basis? I know the question has been asked in several different ways over the course of the conference call, but I think it's a pretty fundamental question going forward.

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

Yes, I agree. And it is, it's a comp located answer. I don't think figuring out the euro impact is that difficult because it's fairly public, and it's -- you know that that's the largest part by far of our international revenue at this point on a year basis. That was the biggest decline that we saw in 2015, without a doubt, in our gross margins was the impact of the euro.

The services piece -- so let me talk about this year. So, we expect gross margins to improve this year. That improvement is directly tied to an increase in the US business versus the international business. There is a pull-down on that gross margin because of our services revenue, and I will go back again and tell you that it is absolutely without a doubt incremental to operating profit on a percentage basis. So operating income, it is accretive to our product gross margins. But having said that, that is a pull-down. And we expect the overall, including the mix on where our forecast is right now for services, to be up this year. If you think that we are kind of in the 44%, 45%-ish range, for the entire year we expect that to be up somewhere between 100 to 200 basis points. Is that correct? I'm looking at you. On the gross margin line?

Roger Shannon - ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary

On the gross margin line? I think we are saying it's flat.

Tom Stanton - ADTRAN, Inc. - Chairman, CEO



For the year. For the year, we are expecting it to be up, although Q1 we are expecting it to be down. We expect the US business to get stronger as we go through the year.

Roger Shannon - *ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary*

That's right.

George Notter - *Jefferies LLC - Analyst*

Got it. Thank you.

Operator

Simon Leopold, Raymond James.

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

Great. Thank you for taking my question. A couple of things I wanted to clarify. First, I want to go back to your commentary on the tax rate, given that we have the R&D tax credit. I want to make sure first of all I heard you correctly that you forecast a mid to high 30% tax rate. Is that what you said?

Roger Shannon - *ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary*

Right. That's correct for the first quarter.

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

So I guess I'm a little bit puzzled, because when I look back at 2015, for the first three quarters of the year, the tax rate was in that range, 37% and change without the R&D tax credit. So I'm just wondering if there's a simple explanation of why you are not seeing more of a benefit.

Roger Shannon - *ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary*

It's a process that is -- you calculate it at the beginning of the year on a quarter-to-quarter basis. So we look at the expected mix in the US business, the international business, and then other items that would fall into the calculation, such as FIN 48 matters. And then as the year goes on, taking into consideration how those events occur, how that mix actually plays out and going forward quarter by quarter, we will adjust that tax rate. So what you've seen the last couple of years in 2014 and 2015 is obviously with the R&D tax credit not being permanent and it actually not being passed by Congress and signed into law until almost the 11th hour, you'd have a negative rate in the fourth quarter as that was finally baked in. So, as we look at it this year, kind of taking those factors into consideration, US domestic mix, the FIN 48 matters as well as R&D tax credit, which is -- has to play out over the course of the year, the rate certainly will start out at a higher level, and then as we move throughout the year, that would be adjusted according to actual results and projections for the rest of the year.

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

And if you've got a higher US mix, that should help for a lower tax rate, or in other words you get more R&D tax credit if more of your revenue comes from the US? Is that correct?

Roger Shannon - *ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary*

I think conceptually I agree with you. I think, again, it depends on the jurisdiction of where the international sales are. Obviously, the US tax rate is higher than basically all countries. Then, as you say, you factor in the R&D. Outside of that, it depends on the jurisdiction of the sales internationally.

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

Okay. And then shifting gears, the internetworking business, we haven't really talked about that on this call today much, in terms of the Q&A discussion. But I can't help but notice the revenue there, while notoriously lumpy, was a bit light this quarter. And I recognize that's a tough comparison versus September. But if we look at the long-term trend, Internetworking as a segment has been coming down. Could you help us understand what's going on there? How much is macro? How much is product maturity? Any kind of insight you can give us towards how to think about that segment of the business?

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

Sure. And it has been a tough one to forecast. And you did hit on the two bigger points there. One is we do have -- there is just flat-out sluggishness in the CLEC market, which I pointed out in our -- in my notes. That has persisted for some time right now. We don't see a significant market share change there. It is -- if I look at the sales into those customers, each one of them has a particular reason, but it's just been slow.

We do also sell to MSO carriers, which traditionally has been a fairly consistent market. You know we went through some inventory issues with one of our larger MSO customers, and in looking at the inventory pull-down and the actual inventory rates, that actually did not clear itself up in Q4, so that was problematical to that customer coming back online. Having said that, we are continuing to progress forward with that product line. IP Gateways is the product line that is the one that is causing the distress in Internetworking. And we just in this quarter -- actually, excuse me, in Q4, we won another large MSO here in the US for internetworking products for our IP gateway products, and that will start shipping sometime around the half. So we are continuing to pick up market share. But having said that, until we get out of kind of this period in the softness in the CLEC market, we are not expecting significant growth in our internal plans even as we do pick up market share.

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

Thanks. And one last one if I might. In prior calls, when we've talked about the issues with foreign exchange, you've suggested that you expected your largest international customer would purchase more units in 2015, but that foreign exchange would lead to less revenue. I'm just wondering if, with the year behind us now, whether or not you delivered on that target of shipping more units into that top customer.

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

I don't know. When I say units, I don't know. So basically if you say on a constant currency basis I think is probably your question?

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

Sure.

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

Constant currency basis for the broadband business, my sense would be probably not. When -- we saw kind of a wholesale shift in Q4 into Q1 of this year. And so I'll go back and check the math, but my sense is probably I wouldn't be surprised if it was a little down even on a constant currency basis.

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

Thank you very much.

Operator

Greg Mesniaeff, Drexel Hamilton.



Greg Mesniaeff - Drexel Hamilton - Analyst

Yes, thank you. In your introductory remarks, you talked quite a bit about currency fluctuations and its impact on business and revenues. Any color on the impact of those fluctuations on component pricing, if there is anything there?

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

Unfortunately not. We buy -- and that is the kind of root issue that we have. Most of the components that we buy are on a dollar basis, including products that we sell to Europe and Asia and Latin America. So we are getting paid in euros in many cases or in pesos and then we are paying our component suppliers in dollars.

Greg Mesniaeff - Drexel Hamilton - Analyst

Got you. And as just a quick follow-up, can you talk a little bit about any product refreshes that you have slated for 2016?

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

We've got a ton. I talked to a little bit on the call. So we are launching and have been actually in the midst of launching a significant upgrade in our optical product line, the broadband access optical product line, including our Class G optics, which we are now trialing. You'll see TWDM products come next year which is NG-PON2 next year. I also talked about our virtual LLT system which we are trialing with a Tier 1 carrier here in the US. That is a significant upgrade. And if you think about where ultimately SDN can go to and what people are looking for, that's a product that right now we're in the midst of a trial or gearing up for a trial with a carrier here in the US. So, you'll see a significant refresh on the optical side and on the system-level side.

On the copper side, the biggest thing going on right now is SUPERVECTING and G.fast. We have the broadest line of G.fast products on the market by far. We support multiple chipsets where most companies support a single chipset in their G.fast products. We have the best performing product out there and we have multiple port configurations. And that is truly a completely different product line. It's not really part of the 5000 per se. It's a kind of standalone product. And then SUPERVECTING is just being rolled out across a broad footprint of our product lines, including the 5000 and hiX. All of those are at some level of completion and will be announced throughout 2016.

Greg Mesniaeff - Drexel Hamilton - Analyst

Great. Thank you for the detail.

Operator

Matt Dane, Titan Capital.

Matt Dane - Titan Capital Management, LLC - Analyst

Thank you. I was curious. You stated that you have -- looking at the flagging customer base that they have committed to taking roughly \$9 billion in CAF II funding. I was kind of curious. How does that compare to CAF I? And is that \$9 billion, is that all of the CAF II that exists out there or would you expect additional commitments even above and beyond that CAF II funding?

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

The \$9 billion is for the rate of return carriers which people tend to think about them as Tier 1 and Tier 2 carriers. And that is basically if you look at the dollars that they have accepted, which is roughly \$1.5 billion per year over the next six years, that's where that number comes from. And as far as will that -- the available was not much more. I think it may have been \$200 million more or something like that that didn't get accepted per year, so the upside to that is basically zero.



Roger Shannon - ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary

I'm sorry to correct you. The first is for the market cap carriers.

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

Oh, okay, so (multiple speakers) Tier 2 and -- Tier 1 and Tier 2s is where the \$9 billion come from. And that's a fairly -- they signed up with the FCC to do deployments on particular footprint expansions and that's fairly fixed, at least in my mind. I don't think it's going to change dramatically. The only way it will change is if they don't live up to their commitments on deployment. And I'll just remind you that once they receive the money for a year, so let's say \$1.5 billion this year, they have to show progress in deploying, they have to deploy 20% this year, by the end of this year, and show to the FCC that they actually made that progress or else those funds get haircut going forward. And they have to do that for the next five years.

There is another pocket of money which is this pocket of money that kind of gets at least clarified hopefully this quarter which are for the rate of return carriers. And that's almost another \$9 billion -- it's actually more than that. It's \$1.8 billion per year for 10 years.

Roger Shannon - ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary

Two years.

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

And that has really yet to be -- yet to start flowing. So that's where the upside would be on the cap piece.

Roger Shannon - ADTRAN, Inc. - SVP Finance, CFO, Treasurer, Secretary

Yes, and I think this is public knowledge. Currently, the Tier 3s, the rate of return carriers receive Universal Services Funding, USF. That's going to be obviously changing with these new rules coming out from the FCC for CAF II. They're talking about a bifurcated plan, two components to it, a model support plan kind of like CAF II for price cap carriers that we just mentioned, and then an existing mechanism, kind of a price support rate of return model like the USF today. So, again, I'm not going to get into what the FCC is going to do. You can look that up. But that's the information as we understand it right now.

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

You had asked also the question how that compares to CAF I. CAF I was really a fixed program. I think it was initially \$500 million and then they kind of rolled into CAF I Phase II, which forwarded some more of that money forward, but it was a fixed dollar amount substantially less.

Matt Dane - Titan Capital Management, LLC - Analyst

Okay, okay. And you talked about the 20% that needs to be committed or spent this year of the \$1.5 billion. I was curious. You said a number of carriers seem eager to spend it or get it out there as quickly as possible. Is that a number that they are far going to exceed as you're sitting here today? The 20% is frankly irrelevant with most of the carriers and they're going to go well above and beyond that, is that how you're (multiple speakers)

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

I don't expect that. I think it will end up where people are doing what they have to to make their commitments. Some of them want to get it done forward and then just kind of reap the benefits in the latter years, but in general, I don't expect to. Let me make sure I clarify this. They don't have to spend 20% of the money. They don't have to spend the \$1.5 billion that's coming this year. They have to cover 20% of the footprint. And however they do that -- so some of them may do the easy ones first, which inherently will be less expensive, and some of them may do the hard ones first and some of them will probably do a mix. So it's not directly dollar-related. It's performance towards their commitment and getting coverage.



Matt Dane - Titan Capital Management, LLC - Analyst

And you talked about that Access piece I think for the \$1.8 billion piece of business that exists out there as being I think -- did I hear 10% to 15% of (multiple speakers)?

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

Yes (multiple speakers) kind of an industry. That's not really my number. It does equate fairly correctly to what we saw in broadband stimulus. Yes.

Matt Dane - Titan Capital Management, LLC - Analyst

Okay. Is that similar for the CAF II as well, that 10% to 15% number?

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

Yes. There's nothing inherently different about what they are doing there from a macro level, so we are comfortable that -- it may turn out different, but at this point, we don't have a better number than that.

Matt Dane - Titan Capital Management, LLC - Analyst

Okay, great. Thank you.

Operator

Tim Savageaux, Northland.

Tim Savageaux - Northland Securities, Inc. - Analyst

Good morning. Just a real quick question on kind of growth expectations domestically for 2016. You had indicated kind of flattish, maybe a little down expectation internationally. The domestic business has grown around 20% and in the last couple of quarters and I think your kind of implied guidance, and given the weakness last year, would be higher than that. What sort of growth expectations, should we be carrying growth expectations in that range of the last few quarters into 2016 for the full year? And would that include anything sort of material in terms of major new Tier 1 business, or should we look at more as kind of run rate business? Thanks.

Tom Stanton - ADTRAN, Inc. - Chairman, CEO

Okay. So I -- we typically won't give a dollar number on full-year guidance. What you said is absolutely correct. We expect this year to be up. We expect this year to be up on the domestic business. We expect the international business to be relatively flat. And that's basically from lack of better visibility to tell us one way or the other. We expect the Company to be up.

We had a fairly strong US. It wasn't just in the last two quarters. The total year was actually fairly strong for the US carrier market. That's probably -- as we get through the year and we see how CAF II unfolds, we absolutely will give more color. But it's still yet to be seen. We think we have got a good handle on Q1, but we really don't have strong visibility past that in the US market.

I do want to -- if you will allow me during your time also, I wanted to go back to Simon's question. So, Simon, your question on a unit basis, the answer that question was yes, DT was actually up on a year-over-year basis. Sorry about that.

Any other questions Tim?



Tim Savageaux - *Northland Securities, Inc. - Analyst*

No. That's great. Thanks.

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

I think we are out of time. In fact, I know we are out of time. So I do appreciate everybody participating on our call and we look forward to talking to you again next quarter.

Operator

This concludes your teleconference. Thank you for your participation. You may now disconnect.

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