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ADTN - Q1 2016 ADTRAN Inc Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by and welcome to ADTRAN's first-quarter 2016 earnings release conference call.

(Operator Instructions)

Please note this call may be recorded.

(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 risk 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 and other risks detailed in our annual report on Form 10-K for the year ended December 31, 2015. These risk 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. - CEO & Chairman of the Board

Thank you, Tanisha. Good morning everyone. Thank you for joining us for our first-quarter 2016 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 Q1 results and I will end with some comments on what we see for the future. Roger will then discuss our Q1 performance in more detail and our financial reporting segmentation that we announced on April 8.

As we stated in our earlier press release revenues for the quarter were \$142.2 million, slightly higher than expected driven by a 7% increase quarter over quarter in our Network Solutions business, partially offset by a seasonal decline in our Services & Support revenue. Our total Network Solutions



revenues including both international and domestic markets came in at \$123.9 million and total Services & Support revenue came in at \$18.3 million. Revenues from our domestic markets came in at \$116.3 million or 82% of the total and international revenues were \$25.9 million for the quarter or 18% of the total.

We continued to see a shift towards North American revenues on a year-over-year basis predominantly due to the growing momentum in the US broadband market and the return to more normal buying patterns in Europe. On a sequential basis, strength in our US customer base was able to overcome the typical seasonal decline we see in this market. International revenue was slightly down sequentially with the expected growth in Europe offset by seasonal decline in the Middle East and Latin America.

Looking at our previous reporting segments, Carrier Network Sales were up slightly year over year coming in at \$118.4 million with US sales up 62% over the same period last year. The year-over-year growth in this area came from increased sales in both Tier 1 and Tier 2 accounts. Enterprise sales came in at \$23.8 million driven by a strong performance in our internetworking product lines.

Our core product areas which include broadband access, internetworking and optical, came in at \$132.9 million and included double-digit quarter-over-quarter growth in our optical and internetworking product groups. Our broadband sales were \$81.8 million helped by continued strength in our GPON product areas and of course CAF-related sales in North America. Our internetworking product category came in at \$34.9 million, up 15% sequentially as sales to carrier customers continued to trend upwards.

During our last call I spoke about some of the innovations we have recently brought to market such as next-generation PON deployment and software defined networking. Our efforts continue to show promise and during the quarter we received our first next-generation 10 gig PON award from a Tier 1 carrier here in the US. And we have multiple trials in several key markets utilizing our SD and controlled architecture.

Additionally, we continue to push our industry lead in G.fast development with now over 60 carriers around the world driving our G.fast infrastructure. We believe that we are entering a period of time where the definition of acceptable competitive broadband speeds are changing rapidly. And although the timing of this shift may fluctuate and be debated, we believe the landscape is changing at an accelerating rate.

It is our plan to make sure ADTRAN is positioned properly to lead this change which as we have seen before will transform the way we interact and work. Finally, for the balance of 2016, we expect the positive momentum we have seen associated with CAF and bandwidth expansion builds to continue as ADTRAN customers who in total have accepted \$9 billion in price cap carrier CAFII funding continue to move forward.

Additionally, we believe that the recent enactment of CAFII rate of return carrier regulations, which provides over \$11.5 billion of government support over 10 years to Tier 3 carriers and results in a transition of the prior USF funding from voice to broadband focus, will be positive for ADTRAN. I would now like Roger Shannon to review our results for the first quarter of 2016 and provide comments on the second quarter as well. We will then open the call up to questions. Roger?

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

Thank you, Tom, and good morning. Before covering our financial results for the quarter I want to touch on the financial reporting segment and product category changes we announced last week.

Consistent with SEC regulations requiring financial disclosure of services revenues when they are consistently expected to exceed 10% of total revenues, beginning with the publication of our earnings for March 31, 2016 quarter we are reporting our financial performance based on two new reportable segments: Network Solutions which includes our network hardware and software solutions, and Services & Support. In addition to these new reported segments we will also report revenue for three new categories: access and aggregation, customer devices and traditional and other products. These three categories include both Network Solutions and Services & Support revenues as applicable.

The performance of our new operating segments will be reported based on gross profit. We will continue to report our selling, general and administrative expenses, research and development expenses, interest and dividend income, interest expense, net realized investment gains and losses, other income expenses and provision for income taxes on a consolidated company-wide basis.

Last week we provided the revised financial reporting structure to give visibility into the new reporting model. And earlier today we provided our recast 2014 and 2015 quarterly and full-year results in the new reporting format on our ADTRAN investor relations website and 8-K filing.

For this quarter only in our earnings release and for this call we will present our current-quarter results in both the new and the previous reporting formats. Revenue for ADTRAN's first quarter was \$142.2 million which is relatively flat compared to the \$142.8 billion for Q1 of 2015 but up 2.3% from the \$139 million we reported for Q4 in 2015.

First for our new segments. Network Solutions revenues for Q1 of 2016 were \$123.9 million compared to \$129.5 million for Q1 of 2015 and \$115.7 million for Q4 of 2015. Services & Support revenues for Q1 of 2016 were \$18.3 million compared to \$13.3 million for Q1 of 2015 and \$23.3 million for Q4 of 2015.

Looking at our new revenue categories, access and aggregation revenues for Q1 of 2016 were \$93.9 million compared to \$92.9 million for Q1 of 2015 and \$96.7 million for Q4 of 2015. Customer devices revenues for Q1 of 2016 were \$32.4 million compared to \$31.7 million for Q1 of 2015 and \$28.3 million for Q4 of 2015. Finally, traditional and other product revenues for Q1 of 2016 were \$16 million compared to \$18.3 million for Q1 of 2015 and \$14.1 million for Q4 2015.

Now turning to our prior reporting format, within our core products, broadband access product revenues for Q1 of 2016 were \$81.8 million compared to \$84.8 million for Q1 of 2015 and \$84.9 million for Q4 2015. Internetworking product revenues for Q1 of 2016 were \$34.9 million compared to \$34.2 million for Q1 of 2015 and \$30.3 million for Q4 2015. And optical product revenues for Q1 of 2016 were \$16.2 million compared to \$12.5 million for Q1 of 2015 and \$13.9 million for Q4 of 2015.

In our legacy products, HDSL product revenues for Q1 of 2016 were \$5.8 million compared to \$6.7 million for Q1 of 2015 and \$4.9 million for Q4 of 2015. Other products were \$3.6 million for Q1 of this year compared to \$4.7 million in Q1 of 2015 and \$5.1 million in Q4 2015.

For our prior reporting categories, carrier systems revenue for Q1 of this year were \$100.2 million compared to \$100.4 million for Q1 of 2015 and \$102.9 million for Q4 of last year. Business networking revenues for Q1 of 2016 were \$35.7 million compared to \$35.4 million for Q1 2015 and \$31 million for Q4 of 2015.

Loop access revenues for Q1 of 2016 were \$6.4 million compared to \$7 million for Q1 of last year and \$5.2 million for Q4 last year. Finally, for our prior segments, Carrier Networks division revenues for Q1 of this year were \$118.4 million compared to \$116 million for Q1 of last year and \$116.7 million for Q4 of 2015. Enterprise Networks division revenues for Q1 of 2016 were \$23.8 million compared to \$26.8 million for Q1 and \$22.3 million for Q4 of last year.

Turning to our geographic mix of revenues, domestic revenues for Q1 of 2016 were \$116.3 million, up \$32.9 million from the \$83.5 million reported in Q1 of last year and \$4.3 million higher than the \$112 million in Q4 of last year. International revenues for Q1 of 2016 were \$25.9 million compared to \$59.4 million in Q1 of last year and \$27 million for Q4 2015.

As anticipated, our European business is up over last quarter but not to the levels of Q1 of last year. The year-over-year reduction also include some effect from the decline of the euro/dollar exchange rate. However, there was no material FX impact versus Q4 of last year.

We have reported -- we have published the reporting of each of these categories on our investor relations webpage at ADTRAN.com. For the quarter, we had two 10% of revenue customers, both in the US. Our gross margin for the first quarter of this year was 46.3%, up from 45.9% for Q1 of 2015 and 44.9% for Q4 of 2015.

The improvement in our gross margin this quarter was primarily driven by regional revenue and product mix shifts. Total operating expenses were \$60.3 million for Q1 of 2016 compared to \$63.6 million for Q1 and \$59.6 million for Q4 of 2015. The decrease in operating expenses compared to Q1 of 2015 is a result of realized savings from structural changes and ongoing expense controls that we put in place in 2015.

Operating income for the quarter just ended was over \$5.5 million, an increase of over 181% compared to the \$1.96 million in Q1 of last year and 97% ahead of the \$2.8 million reported in Q4 of last year. As described in the supplemental information we provided in our operating results disclosure, stock-based compensation expense net of tax was \$1.3 million for Q1 of 2016 compared to \$1.5 million for Q1 of last year and \$1.7 million for Q4 of last year.

All other income net of interest expense for Q1 of 2016 was \$2.6 million compared to \$3.5 million for Q1 of 2015 and \$2.4 million for Q4 of last year. The Company's tax provision for Q1 of 2016 was \$3.1 million or an effective tax rate of 37.93% compared to a tax provision rate of 39.8% for Q1 2015 and negative 9.64% for Q4 of 2015.

As a reminder, the net tax benefit in Q4 of 2015 was a result of our realizing the full-year impact of US legislation passing the research and tax -- research and development tax credits at the end of 2015. Net income for Q1 of 2016 was \$5 million compared to \$3.3 million in Q1 of 2015 and \$5.7 million in Q4 2015. Earnings per share on a GAAP basis assuming dilution for Q1 of 2016 were \$0.10 per share compared to \$0.06 per share for Q1 of last year and \$0.12 for Q4 of 2015.

As previously discussed, our Q4 2015 earnings were improved by approximately \$3 million, or \$0.06 per share due to the fourth-quarter extension or the R&D tax credits.

Non-GAAP earnings per share for Q1 of this year were \$0.14 per share compared to \$0.10 for Q1 of last year and \$0.16 for Q4 of last year. Non-GAAP earnings per share exclude the effects of amortization of acquired intangibles 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 \$92.1 million at quarter-end, up from the \$91.5 million in Q4 of last year. Net trade AR were \$67.5 million at the quarter-end, resulting in a reduction in our DSO to 43 days compared to 57 days at the end of quarter-one January 2015 and 48 days of the end of Q4 2015.

Unrestricted cash and marketable securities net of debt totaled \$272.3 million at quarter-end after paying \$4.5 million in dividends and repurchasing just under 600,000 shares of common stock for \$11 million during the quarter. For the quarter we produced \$15.7 million of cash flow from operations.

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 Q2 2016 revenues will be up on a percentage basis in the low to mid teens.

Taking into account currency exchange rates and anticipated mix, we expect that our second-quarter gross margins will be flattish with our first-quarter results. We also expect operating expenses for the second quarter will be consistent with the quarter just ended after adjusting for any difference in sales commissions based on increases in revenue. And we anticipate the consolidated tax rate for Q2 to be in the mid to high 30% range.

We believe the significant factors impacting revenue and earnings realized in 2016 will be the following: macro spending environment for carriers and enterprises, currency exchange rate movements, the variability of mix in 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.

With that I will turn the call back over to Tom.

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

Thanks very much, Roger. I appreciate that comprehensive report. And it's a little bit longer this time just so the listeners know because we had to cover both our old way of presenting numbers and our new way of presenting numbers.

With that, Tanisha, I think we're ready to open up for any questions that people may have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Rod Hall, JPMorgan.

Rod Hall - JPMorgan - Analyst

Yes, good morning guys thanks for take my question. Nice job on the numbers. Nice to see the numbers moving ahead of expectations here.

Still I guess a couple of things. One I was curious what you guys, the international numbers were a little bit weak, curious what you guys are thinking embedded in your Q2 guidance on international? And then just if you could give us any color on how that plays out through the year.

Secondly, the services gross margins have continued to slip a little bit. I just wonder, do you guys expect stability on that gross margin line for services sometime soon? Can you give us any idea where that stabilizes?

And then I guess the third question I've got is on CAF-related spending, I know you called out Tom, or Roger, as a risk the timing of this. But what sort of visibility have you got there on CAF? How do you expect that to trend and where do you think it peaks?

Do we -- do you have any idea whether CAF spending peaks the second half of the year or where you're expecting that would be helpful to us? Thanks.

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

Sure. So we will cover these in the order that you presented them.

The first one, which is just our international business in general, so do we expect that a stronger US content this year than international content our. Outlook for the entire year really has baked it at this point in time kind of a flattish international business this year with what's going on with our large Latin American customers and what's going on in Europe.

Actually we'll hopefully we will do better than that. But that's kind of where we're looking at the entire year at this point. And so the growth really for the business is coming from the US side and that will be consistent throughout pretty much every quarter.

We don't have a lot of visibility into the fourth quarter but that's what we're looking at at this point in time. The second question was on services gross margins. Do you want to touch on that?

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

Sure. So consistent with the expanding and the double-digit growth that you see in services, that has transitioned toward more N&I as opposed to maintenance, more maintenance in the past.



So as that mix has increased in N&I the margins on it obviously are lower than the maintenance margins which have much lower cost of goods component. So as the services continue to grow and we do more N&I turnkey implementations that's kind of getting to more of a normalized level.

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

The other thing, if you look at the Q1 percentage basis on gross margins I think if we look at it at least for this year, we don't know what's going to happen next year, but for this year we would probably see -- we would expect similar. Because we saw the N&I business actually start picking up second quarter of last year and at this point it is a large piece of our business, right. I hope that answered that question.

And then on CAF, so the peak, it's a good question. I will tell you not all of the CAF players are -- not all the people with CAF for let's say the larger carriers, the Tier 2 carriers, are really in full deployment yet. So I would say we're still fairly early in to that process.

And the CAF, the new CAF for the rate of return carriers really have yet to be seen. So whether or not we hit a run rate this year that's the peak run rate or next year my sense would be we're probably won't hit that peak this year, especially because half the money really isn't even online yet. But we'll just have to wait and see how that plays out.

Rod Hall - JPMorgan - Analyst

Great, all right, thanks guys.

Operator

Simon Leopold, Raymond James.

Simon Leopold - Raymond James & Associates - Analyst

Great, thank you for taking a question. First, a very quick clarification. A subtle change in the language in your press release when you're talking about the outlook.

We note that in your second paragraph you've added longer term at the beginning of the sentence we expect further improvement in the carrier environment as compared to the prior quarter, your fourth-quarter report. So I know it's a subtle change but I wanted to get a sense of what was the thinking behind adding that phrase longer term in terms of what's changed versus the prior quarter?

The other thing I was hoping to ask about is an update on the G.fast trials in Europe. You noted more than 60 carrier trials.

I'm most interested in the progress of the BT trial, if there's any update you can offer in terms of timing or outlook. And then the last thing is in terms of the rate of return carriers, I wanted to see if you could give us a little bit of perspective on your competitive position with this group?

And I'm asking because typically we think of your strength with more of the Tier 2 carriers and we tend to think of you as being basically holding a lower share of those smaller rate of return carriers. And I want to see if that's a fair assessment or not. Thank you.

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

Sure. So first of all the longer-term comment was not meant to depict anything on the shorter term. And I will be honest with you, when these things are derived we don't necessarily look and see exactly how they reflected back on the exact comments we gave in the previous quarter.

Maybe we should. The intention there was to say that we really do think that we're in a longer-term upgrade cycle.

So I mentioned on my comments we're very much focused on CAF and I think many of the people that follow us are focused on what's going to happen with CAF funding here in the US. But I think we're in a backdrop where we really think that the infrastructure is in general going to go through an upgrade cycle because of what's happening in the MSO space and what's happening with alternative carriers. And I think so the longer term was just meant to say that we assumed this to be a longer-term cycle.

As far as what's going on in Europe with the G.fast trials that's still open. So we continue to work with the large carrier over there that's going through the trial. I think we're positioned fairly well, we have a very good product set, I think -- from everything that we see outwardly we're just going through the process.

But we have no real word on exactly. There has been no decision at this point in time.

And then your last one was on the rate of return carriers. And the answer to your question is kind of yes and no. So we tend to deal with larger carriers, so the larger Tier 2s, the Tier 1s and then the larger Tier 3s.

So if you look at it from a pure customer account basis then we do not have the leading market share. If you look at it from the number of access lines that are out there in the Tier 3 space, so the number of actual lines and customers that that base, that market is actually serving, then we actually do have the leading market share. So it's depending on how you slice it up.

So I would say if it is going to be beneficial to us as to which base of carriers end up accepting and implementing plans on their particular customer base, I think we don't yet -- I don't think anybody knows that yet. I do think that our penetration into that base is meaningful and that we would see a benefit from it. But I can't really tell you who's going to benefit more.

Simon Leopold - *Raymond James & Associates - Analyst*

And can you just remind us of the timing of the rate of return decision process? And that's it for me.

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

Sure. Well Roger I think has got that.

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

Sure. So the FCC released the regulations actually just a couple of weeks ago. So what they came out with was as expected the two prong or two model approach.

So the rate of return carriers are going to have to go through an exercise to where they evaluate their funding based on both of these approaches and see which is most beneficial to them. So the first one is what they are calling Alternative Connect America Model or A-CAM. And that model is similar to price cap CAF where the funding is based on the number of locations the carrier commits to building out broadband over 10 years.

And that does have a 40% completion requirement within four years and 10% per year for each year after that. So that's one model.

The other is the existing rate of return support model. And in that model the return is being reduced from today's 11.25% to a 9.7% rate of return over six years. But the new wrinkle to this is that the FCC is also requiring some targets for buildout into the 10.1 megabits per second broadband.

So they are going to go through those exercises and obviously determine which is the most beneficial to them. One new twist in the regulations that came out that had not been expected or talked about much before we saw them was some additional sweetener that the FCC had put in. We had expected the \$10 billion over 10 years but there was an additional \$150 million to \$200 million per year added to support additional broadband buildout.



And then the other thing just a kind of add on what Tom mentioned, this is in some ways this rate of return carrier funding is not necessarily incremental to these carriers because it's a transition of the USF to CAFII. This \$150 billion per year is incremental but also --

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

\$150 million.

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

\$150 million per year, I apologize, is incremental. But what is obvious in this is that there is a transition for more of a voice related to broadband related.

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

Did that answer your question? Thanks very much.

Simon Leopold - Raymond James & Associates - Analyst

Is there a date for when that process of review is completed?

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

So we expect from what we're hearing that the money will start flowing in the back half of this year.

Simon Leopold - Raymond James & Associates - Analyst

Great, thank you.

Operator

(Operator Instructions) Doug Clark, Goldman Sachs

Doug Clark - Goldman Sachs & Co. - Analyst

Hi, thanks for taking my question. My first one is actually on the 10% customers for the quarter. Assuming that those are the same US customers, 10% customers from 2015, your revenues with them have been up nicely kind of year on year.

Wondering what's driving that. Is that market share gains, project-related spend, is the competitive environment changing within those customers?

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

Whether or not it's changing, so some of it is CAF-related spend and we do have a good position with our CAF product line. But our market share -- I would say our market share has been pretty stable at those accounts in general. In Tier 2s we have dominant market share and we're seeing more spend, and some of that is CAF-related spend, some of it is specific project bandwidth increase-related spend, so we're just seeing them just doing more.



Doug Clark - *Goldman Sachs & Co. - Analyst*

Got it. Then my follow-up question is one of the Tier 2s, Frontier, acquired or completed the asset acquisition from Verizon. Wondering if what the timeline of investment that you would expect from them on that would be and if you actually see that as kind of a positive uplift in terms of your opportunity to sell into the customer?

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

Yes, so without getting too specific on any customer, typically we see a benefit whenever there are acquisitions, property acquisitions by the carriers. Because many times those properties have not been invested to the level that you would want to see and you would also see some commitments made to the PUC. And I would just say that that is a good customer of ours.

These type of buildouts usually have timetables that are published to the extent that there are PUC commitments. But in general it's a positive thing that plays itself out over several quarters. Are you still there?

Doug Clark - *Goldman Sachs & Co. - Analyst*

Yes, and then maybe one additional follow-up. You had mentioned in terms of the international activity the division between Europe and Latin America. Can you give a little bit more detail on expectations for Latin America throughout the year for 2016?

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

Yes, I'm really -- the thing is that I'm really trying to buy myself some leeway there because we have multiple projects in both Latin America and in Europe with the specific customers that tend to lead those regions. So some of those include PON deployment, some of those include copper-based vectoring deployments. So I'm just giving myself some latitude, to the extent that we see -- that we expect one to be up and we are giving ourselves latitude for the other to be down or vice versa.

And if we're lucky both of them will be up. But I will tell you in both of those regions we have multiple projects that we are getting through different phases of lab implementation, either lab trials or in some cases OS implementation.

Doug Clark - *Goldman Sachs & Co. - Analyst*

Great. Thanks a lot.

Operator

Rich Valera, Needham & Company.

Rich Valera - *Needham & Company - Analyst*

Thank you, good morning. Tom, you mentioned a new 10 gig PON win with a Tier 1 carrier I think in your prepared remarks. Can you give any more color on that in terms of potential magnitude or timing of ramp on that win?



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

I doubt if it will be this year just because it's a Tier 1 and it takes a while to get through the integration cycle. So I wouldn't expect any revenue this year. And I don't know -- the reason for the comment was more about the fact that our 10 gig product development is actually starting to bear fruit and we're starting to see movement in that.

And as you probably know the 10 gig developments that are targeted after the carrier market as well as 10 gig developments that are targeted after the MSO market. But having said that, I really don't have a lot more color to give you until this thing starts to roll that. I know that there's some specific plans for the rollout but they will not happen this year.

Rich Valera - Needham & Company - Analyst

That's helpful. And then I know you won't be reporting on this category specifically going forward, but internetworking was pretty solid this quarter, I think better than probably most people expected it to be.

Can you give any color on the kind of ebbs and flows in the business and how you see -- I know you won't really guide for the rest of the year, but how you sort of feel about generally speaking that enterprise piece of your business as you look out at the rest of 2016?

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

Sure. So the internetworking has quite a few different products in it typically driven by IP gateways. The strength that we saw this year was more, excuse me, that we saw this quarter was on the carrier side, our carrier distribution channels and where they're using it in bundled products.

And it's -- it was kind of expected -- to be honest with you, it's been expected for a long time. So as you know that market was slow pretty much all of last year and we were just glad to see it start to pick up. I'm not envisioning that as being a trend.

I think we need to wait a couple more quarters and see what it does. We have introduced quite a few different products to that area. And as you are probably aware we are also starting to introduce enhanced SBC functionality and our E&F product line into that market place.

But we're seeing, on the RFP front we're doing better than we probably would have expected where we have won some additional business within the MSO that product category. But that is yet to be deployed. So right now we're on the legacy -- I shouldn't call them legacy, let's say our incumbent customer base and it's just doing better

Rich Valera - Needham & Company - Analyst

Okay, that's it for me. Thank you gentlemen.

Operator

Fahad Najam, Cowen.

Fahad Najam - Cowen and Company - Analyst

Thank you for taking my call. Kind of going back to the international segment piece, if I go back a few quarters ago you had highlighted the business internetworking product and specific with the German telecom operator. When should we expect that project to start driving non-US revenue?



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

Good question. And you're absolutely right. That project is over a year late.

The project is still very much a funded project. It is the overall forecast for that project is still very much intact. We did start shipping a little bit of it.

In fact, I think we started shipping a little bit of it actually towards the tail end of last year. We shipped a little bit more this year but it really hasn't launched.

Our expectation is we would see the launch of that project either at the tail end, now at this point in time at the tail end or early next year, and we would see it start ramping forward at this point. I will say that the forecast from the customer has not changed. It's just been incredibly delayed due to technical difficulties which by the way were not ours.

So we're still hopeful. But I don't think -- we're at this point in time not forecasting a lot for that project this year. You'll see that showing up in our forecasting for next year.

Fahad Najam - Cowen and Company - Analyst

Got it. And just kind of staying with the international team, in terms of if you can give us some color on the competitive dynamics, any pricing changes that you've noticed, competitive platform, the Huawei and other competitors, any change in the outlook on the competitive front?

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

No, understanding that there's been -- that there's always pressure in international markets, especially where our two larger competitors are in there competing, there's always pressure. But I would say that that pressure hasn't significantly changed.

Our Chinese competitor tends to be very aggressive. We tend to understand where they are going to come in at. And then our European competitor is also aggressive, but typically not at the same level.

Fahad Najam - Cowen and Company - Analyst

Got it. Thank you.

Operator

Matt Dane, Titan Capital.

Matt Dane - Titan Capital Management, LLC - Analyst

Great, thank you. I was curious, so the CAF spend that has started flowing, is it ramping faster or slower than you expected, rolling the clock back to the beginning of the year?

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

I would say in general it's about where we expect. There's always for us \$5 million one way or the other maybe material in a quarter but it's not material in the overall picture.



And I would say pretty much it's where we expected it to be. And the outlook for the rest of the year is pretty much where we expect.

Matt Dane - *Titan Capital Management, LLC - Analyst*

Okay. And my second question is around G.fast and the 60 or so trials that you have going on right now. When would you expect some major wins to start flowing through and real revenues to be generated from all those trials?

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

Okay, so it depends on the size. And G.fast is a little different than maybe some of the other technology -- maybe not so much different. But the larger carriers tend to jump out first when it's a new technology and then the smaller carriers follow suit.

So let's say in most cases that we're dealing with we're dealing with larger carriers. And they tend to have an OS integration cycle that's anywhere from 12 months to 18 months.

Having said that, we expect our first G.fast revenue with larger carriers to begin really kind of in the first half of 2017. We may see it a little bit this year but we really expect it to be material in the first half of next year.

Matt Dane - *Titan Capital Management, LLC - Analyst*

Okay, great. Thank you.

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

Did that cover you?

Matt Dane - *Titan Capital Management, LLC - Analyst*

That's helpful. Thanks, Tom.

Operator

(Operator Instructions) Tim Savageaux, Northland Capital.

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

Hi, good morning. First, a quick clarification.

Reading kind of around the guidance, low to mid-teen sequential, for some reason I thought I heard mid to high teen sequential. Can we clarify what kind of revenue guidance you gave for Q2?

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

It's low to mid teens.



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

Low to mid. Okay. Eternal analyst overoptimism I suppose.

Okay, well given that either way let's call it mid-teens, stay with the optimistic bent, I think you also guided gross margins flat sequentially. And given that degree, or flattish, given that degree of revenue increase I might expect some degree of leverage there. I wonder if you could talk more about the sort of levers driving gross margins given the strength of sequential revenue increase?

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

Well there are things that factor into that -- let's say we have three or four major factors. One of course is international versus US content. We talked about that a little bit earlier.

You would surmise to say that we don't see a material change, although we expect through the rest of this year that the US is going to grow at a faster rate. That kind of bodes to your comment. There is the service mix which changes from quarter to quarter.

We do think that we're in the range as far as gross margin for the services business. We're kind of in the range where it may fluctuate but we don't see dramatic fluctuations going forward. But that percentage may be a higher percentage in any one quarter than any other quarter.

And then there is still something that we cannot maybe talk so much about, but there is product mix, and I think we mentioned that. So coming into any quarter we're trying to forecast what the chassis mix, what type of chassis and line card mix that is going into any particular customer at any particular time during that period of time.

So it is not all known but those are the things that we actually deal with. So you can take from that what you will but it's just what our current view is.

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

Okay great. I will pass it on. Thank you.

Operator

George Notter, Jefferies.

George Notter - *Jefferies & Company - Analyst*

Hi, thanks very much guys. I guess I wanted to come back to a prior question about the new subsidy program for rate of return carriers.

So when exactly do you guys expect them to decide which of the two subsidy models they will go forward with? I guess the larger question here is simply do you expect to see any potential risk in spending there as these guys manage through this transition? Could they slow down ahead of this decision point, would they speed up afterwards or how do you think the tenor of spend would play out with these rate of return carriers before, during and after the transition? Thank you.



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

George, that's a really good question and I'm sure that there's multiple answers depending on who the carrier is. That particular market has not been -- that -- the Tier 3 market has not driven a lot of our upside. We have been very much focused more on the Tier 2.

So I guess from where our revenue level is right now and our expectations through this year on the Tier 3 market we don't see a lot of downside. Because it hasn't been -- we haven't seen the uptick we saw in the Tier 2. But you're right, there is a decision factor, there could be a delay in that market.

I don't see that delay being material to us at this point in time. And as to when how they are going to make those decisions, each carrier is different as you know. Some of these are fairly small, family-operated organizations and some of these are fairly large, diverse organizations that will look at things completely differently.

So I don't have a lot more insight to be honest with you than you probably already have yourself there.

George Notter - Jefferies & Company - Analyst

Got it. Okay, thank you.

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

Okay. So at this point in time I see I think we're pretty much done with our question queue. So I appreciate everybody for joining us on our call. And I look forward to talking to you next quarter.

Operator

That does conclude today's program. We'd like to thank you for your participation. Have a wonderful day and you may now disconnect.

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