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ADTN - Q4 2016 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 2016 earnings release conference call.

(Operator Instructions)

During the course of the conference call, ADTRAN representatives expect to make forward-looking statements which reflects management's best judgment, based on factors currently known. However, these statements involve risks and uncertainties including the successful development and market acceptance of core products, the degree of competition in the market for such products, the product and channel mix, component cost, manufacturing efficiencies and other risks detailed in our annual report on Form 10-K for the year ended December 31, 2015 and Form 10-Q for the quarter ended September 30, 2016. 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, Roxanne. Good morning everyone. Thank you for joining us for our fourth-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 Q4 results and I will end with some comments on what we see for the future. Roger will then discuss our Q4 performance in more detail and we will then open the call up for questions, any questions that you may have.

As we stated in our earlier press release revenues for the quarter were \$163 million, coming in ahead of expectations, seasonally down 3% but sequentially up 17% year over year. Our total Network Solutions revenues, including both international and domestic markets, came in at \$126.8 million and total Services & Support revenues came in at \$36.2 million, another new record for the Company.



Revenues from our domestic markets came in at \$123.7 million or 76% of the total and the international revenues at \$39.3 million for the quarter represented 24% of the total. On a year-over-year basis our domestic revenues increased 10% as Tier 1 US vending continued to accelerate driven by an increase in demand for our higher bandwidth vectoring solutions, CAF II and a record performance by our US services team. The last two items continue to have a positive effect on our Tier 2 performance and our Tier 3 business also saw a material pickup in both a year-over-year and sequential basis.

For the full-year 2016 our domestic business was up a very solid 20% over 2015, driven by healthy increases in both Tier 1 and Tier 2 customers.

Moving on to our international business, here we also had a solid quarter, growing 46% over the same period last year as we continue to benefit from growth in vectoring shipments to Europe and began to see initial shipments of our G.fast products.

Moving down a little deeper, our access and aggregation category had another solid quarter, up 24% over the same period last year with growth both domestically and internationally. For the full year, the access and aggregation category was up 8% which included the impact of the slow start to our European business. Also of note during the fourth quarter we shipped our 10 millionth vectoring capable port, making vectoring the fastest-growing product in our Company's history.

Customer devices also saw strength during the quarter, up 11% over the same quarter last year and up 10% for the full year. Finally, our traditional and other product category was down 15% for the quarter and down 9% for the full year, due mainly to expected slowdowns in our older generation HDSL and NetVanta products.

We entered 2016 with a sharp focus on our ultra-broadband product and services strategy with a belief that we would see significant increases in carrier capital spending in this area. This shift driven by increasing competition, customer demand and regulatory encouragement did materialize, albeit at various degrees in most of the markets that we serve.

We enter this year with the same conviction, yet better positioned. We have increased our product and services footprint in both domestic and international markets. We have increased our services capability to match the market demands and, very importantly, our Mosaic cloud platform has been selected by multiple carriers around the world.

We believe ADTRAN is the only access vendor with SDN controls, software modularity and application virtualization and continues to lead in the development of next-generation access architectures.

Looking forward, our focus remains on being the world's most comprehensive access solution provider with clear industry-leading solutions in fiber access and ultrahigh speed copper. With the world's most complete access virtualization products we believe we are well-positioned to capitalize on the evolution in access as carriers around the world of upgrade their infrastructure to meet customer demand.

I'd now like Roger Shannon to review our results for the fourth quarter of 2016 and provide some comments on the first quarter of 2017, as well. We will then open the call up for any questions. Roger?

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

Thank you, Tom, and good morning. I will speak about our fourth-quarter results and discuss what we see for the next quarter. During my report I will be referencing both GAAP and non-GAAP results.

ADTRAN's fourth-quarter revenue was \$163 million, which is up 17% compared to the \$139 million for quarter-four 2015 and down 3% from the \$168.9 million we reported last quarter. Our Network Solutions revenues for Q4 were \$126.8 million, up 10% from the \$115.7 million for quarter four of last year, led by our continued rebound in our European Tier 1 business and seasonally down from the \$136.3 million reported for Q3 of 2016.



Our Services & Support segment continued its strong growth as Q4 2016 revenues were \$36.2 million, up 55% compared to the \$23.3 million earned in quarter four of 2015 and 11% ahead of the \$32.6 million reported for quarter three of 2016. Across our revenue categories, access and aggregation revenues for quarter-four 2016 were \$119.7 million, up 24% compared to \$96.7 million for quarter four of 2015 as we saw growth in our US broadband products and services and internationally in our European access business, and down slightly compared to the \$120.6 million for quarter three of 2016.

Customer devices revenues for the quarter were \$31.4 million, up 11% compared to \$28.3 million for quarter four of 2015 and down 5% compared to \$33 million for quarter-three 2016. Finally, traditional and other product revenues for quarter-four 2016 were \$11.9 million, down 15% compared to \$14.1 million for quarter four of 2015 and down 22% compared to \$15.3 million for quarter-three 2016.

Domestic revenues for Q4 2016 were \$123.7 million, up \$11.7 million or 10% from \$112 million we reported in Q4 of last year and down \$4 million or 3% from the \$127.7 million in quarter-three 2016. International revenues for quarter four of 2016 were \$39.3 million, up 46% compared to \$27 million in quarter four of last year and down 5% from the \$41.2 million for quarter three of 2016. We published the reporting of each of these categories on our investor relations webpage at ADTRAN.com.

For the quarter we had three 10% of revenue customers. Our GAAP gross margins for the fourth quarter of this year were 43.4% compared to the 44.9% for both quarter four of 2015 and quarter three of 2016. The sequential decrease in our fourth-quarter gross margins was primarily driven by a product mix shift in our international revenue, a higher services mix and a weaker euro in Q4.

The year-over-year decrease in gross margins was due to higher services and international revenues mix and an increase in warranty expense associated with a defect in a part provided by a third party supplier which we discussed in Q3. Total operating expenses on a GAAP basis were \$66.5 million for quarter-four 2016 compared to \$59.6 million for quarter four of 2015 and \$65.7 million for quarter three of 2016.

On a non-GAAP basis, our Q4 operating expenses were \$63.4 million compared to \$57.3 million in quarter four of last year and \$63.1 million last quarter. The difference between GAAP versus non-GAAP OpEx in Q4 is due to amortization expenses associated with our active EPON and RFoG products acquisition in Q3 and equity-based compensation. The sequential increase in GAAP operating expenses were a result of an increase in equity and variable incentive compensation due to stronger results for 2016 along with the previously mentioned amortization expenses.

The year-over-year increase in OpEx was a result of the factors just mentioned along with customer-specific projects. Operating income on a GAAP basis for the quarter just ended was \$4.3 million as compared to the \$2.8 million reported in Q4 last year and \$10.1 million earned in quarter three of this year. The decrease in Q4 GAAP operating income as compared to Q3 is attributable to lower revenues, a higher services mix, a product mix shift in our international revenues and the slight increase in our Q4 operating expense.

Non-GAAP operating income for Q4 2016 was \$7.5 million compared to \$9.4 million in quarter four of last year and \$14.3 million in quarter three of 2016. As described in our supplemental information provided in our operating results disclosure, stock-based compensation expense net of tax was \$1.8 million for quarter four of 2016 compared to \$1.7 million reported in quarter four of last year and \$1.3 million in quarter three of this year. Expenses related to amortization of acquired intangibles was \$724,000 net of tax compared to \$305,000 in quarter four of last year.

All other income net of interest expense for Q4 of 2016 was \$2.6 million compared to \$2.4 million for quarter four of 2015 and \$5.4 million for quarter three of this year. Quarter three included a \$3.6 million bargain purchase gain associated with the previously mentioned acquisition of active EPON and RFoG assets from another company. Gains from our FX hedging program resulting from an increase in our international business were recognized in other income.

The Company's tax provision for quarter four of 2016 was a benefit of \$700,000 for an effective tax rate of negative 11% compared to a tax provision rate of a negative 10% for quarter four of 2015 and 20% for quarter three of 2016. The decrease in the tax rate is primarily attributable to additional R&D benefit tax credit in the quarter, benefits recognized from foreign tax filings and the expiration of statutes. Net income for Q4 2016 was \$7.6 million compared to \$5.7 million in quarter four of last year and \$12.4 million in quarter three of 2016.



Earnings per share on a GAAP basis, assuming dilution for quarter four of 2016, were \$0.16 per share compared to \$0.12 per share in quarter four of last year and \$0.26 per share last quarter. Non-GAAP earnings per share for the fourth quarter of this year were \$0.21 compared to \$0.16 per share for quarter four of last year and \$0.26 per share for quarter three of this year.

Non-GAAP earnings per share excluded the effect of amortization of acquired intangibles, restructuring expenses and stock compensation expense in each quarter and the bargain purchase gain from the acquisition in Q3. The reconciliation between diluted GAAP earnings per share and diluted non-GAAP earnings per share is provided in our operating results disclosure.

Now turning to the balance sheet, inventories were \$105.1 million at the end of quarter four, up from \$96 million last quarter. The increase in inventory is due to customer-specific projects, cost avoidance purchases and acquired inventory from our acquisition of EPON and RFoG product lines.

Net trade accounts receivable were \$92.3 million at quarter end, resulting in a DSO of 52 days compared to 42 days at the end of quarter-four 2015 and 55 days at the end of quarter-three 2016. The year-over-year DSO change was due to higher international sales and the sequential improvement for the quarter was a result of customer mix.

Unrestricted cash and marketable securities net of debt totaled \$256 million at quarter end after paying \$4.4 million in dividends and repurchasing just over 161,000 shares of common stock for \$2.9 million during the quarter. For the quarter ADTRAN produced \$14.2 million of cash flow from operations.

Looking ahead to the next quarter, the book and ship nature of our business, the timing of revenues associated with large projects, 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 quarter-one 2017 revenues will be up in the low to mid single digits, better than the mid-single-digit season decline that we typically see.

Taking into account the potential impact of currency exchange rates and anticipated mix we expect that our first-quarter gross margins on a GAAP basis will be in the low 40% range, driven by new footprint growth in our international business. We are also expecting GAAP operating expenses for Q1 2017 to be slightly lower than Q4 2016. Finally, we anticipate the consolidated tax rate for Q1 to be in the mid-30% range.

We believe that significant factors impacting revenue and earnings realized in 2017 will be the following: macro spending environment for the carriers enterprises, currency exchange rate movements, the variability of mix and revenue associated with project rollouts, professional services activity level both domestic and international, the timing of revenue related to the Connect America fund projects, the adoption rate of our broadband access platforms and inventory fluctuations in our distribution channels.

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

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

Great, thanks, Roger. Roxanne, at this point we are ready to open up to any questions people may have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Rod Hall, JPMorgan.



Rod Hall - *JPMorgan - Analyst*

Hi guys, good morning. Thanks for taking the question.

So I wanted to kick off, I guess, and ask about the gross margins, dig into that a little bit. You guys talked about, I guess, mix in international services and weak euro. I wonder, could you break out how much the euro change affected the gross margin just so we can understand the sensitivity there?

And then I also wanted to see if you could talk a little bit about the pricing environment. Are you seeing any changes there or are we strictly here looking at euro impacts and mix impacts? And then I had a follow-up to that.

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

Sure. First of all, I think the order that Roger, correct me if I'm wrong, that you spoke in is the order that they actually impacted the business.

So the biggest one was international mix followed by services and then followed by the euro. So the euro impact was the least of the three in just we do pick a little bit of that back up in other income.

As far as the pricing environment is concerned it's actually I would say normal. US product gross margins were actually pretty good, pretty much in line with what they happen over the last couple of years. Without a doubt the biggest impact is international mix.

Rod Hall - *JPMorgan - Analyst*

Okay. Thanks. I wanted to just follow up on the big G.fast project in the US that I think you guys are participating in.

Could you just comment, there's some M&A activity around that which may or may not happen depending on which tweet you read which day. I just wonder could you just comment on whether you see M&A affecting that project from a timing point of view or sizing point of view? At the moment it just seems like it's going ahead regardless.

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

It seems like it's just going ahead regardless. As you know, we had started a field trial for the outer region deployment of that. We still fully expect to be starting shipments for that customer in the first half of this year.

Rod Hall - *JPMorgan - Analyst*

Okay, and then just one last one for me. And I doubt you've got an update on this, but the administration change coming in, there's been a lot of talk, a lot of focus on infrastructure.

Obviously broadband infrastructure is one of the critical parts of that for the US given the weakness in our infrastructure. Could you just comment on whether you have seen any movement in the direction or mentioned as people talk about infrastructure investment in projects and additional broadband funding from the government beyond the CAF I and II projects?

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

Not a whole lot -- well, especially if you say not beyond the CAF II projects. CAF II did move forward. There was a milestone towards the tail end of last year that I think was positive for the Tier 3 carriers.

But the direct answer to your question is no. We agree with you that the general sense is that the incoming administration is going to be more friendly to infrastructure investment, but nothing that's really tangible at this point.

Rod Hall - JPMorgan - Analyst

Great, thanks guys.

Operator

Doug Clark, Goldman Sachs.

Doug Clark - Goldman Sachs & Co. - Analyst

Great, thanks for taking my question. My first one is on the first-quarter guidance. Can you talk a little bit about expectation split between the US versus international business and sequential growth there?

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

Yes, without a doubt the international business is strong. And one of the benefits we have for that with that business is we typically have greater visibility because of the dominant customer in that segment. So I can speak to some specificity on that.

But that is we are expecting a strong year out of that customer. And it's going to start -- their typical seasonality had been, if you look historically had been front-half loaded where you see really more back-end loaded, let's say Q1 Q2 versus Q2 Q3 in the US. And that's what we are expecting, although we've got a lot of momentum coming into this year, of course, with our domestic business, as well.

But I have very strong visibility to what's happening with our European customer base. Did that answer your question?

Doug Clark - Goldman Sachs & Co. - Analyst

That does. I'm wondering if you can give that granularity on the US business in the first quarter, as well. So is that going to be down sequentially offsetting some of the growth in the international business?

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

The reality is I don't know yet. The order flow coming out of the year was very strong.

We typically, in Q4 we typically see a downtick in the second half of the quarter, both European business and our domestic business. And I will just say the order flow for the entire quarter was very strong both US and international.

Doug Clark - Goldman Sachs & Co. - Analyst

Okay, that's helpful. Then my other question is on the services mix.

Obviously rose as a percentage of revenues this year and in the fourth quarter, as well. Does that continue to tick up higher throughout 2017 or do we start to face some more challenging comps where that might stabilize as a percentage of revenue?

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

That's a good question. I would expect it to tick up on a percentage basis. I think the unknown there is the G.fast ramp-up, both in the US and outside of the US.

So a lot of the tick up in services is vectoring and CAF related. We sell more product but we also sell more services. And on a project-by-project basis one may be a higher percentage than the other.

So you will see both of those grow this year. Our G.fast revenue typically doesn't have the same level of service component. So to the extent we actually see that come on more material in the second half, then I think that would be an offset to the mix shift.

Doug Clark - Goldman Sachs & Co. - Analyst

Okay, great. Thanks a lot.

Operator

Michael Genovese, MKM Partners.

Michael Genovese - MKM Partners - Analyst

Great, thanks. So it sounds like the gross margins are where they are and where they are headed in the first quarter because you are winning a lot of new footprint putting out a lot of new chassis. So I guess that probably implies that there will be a mix towards cards later and that gross margins will go back up.

I wanted to ask what can they go back up to? The high 40s seem awfully far away from here, but is high 40s still something we should be thinking about and what kind of time frame to get there?

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

If you would have told me mid- to high 40s I'd say yes. The high 40s themselves, some of that is going to depend on does the euro weaken or strengthen because that as you have seen historically has had an impact on us. But what you said at the very beginning of the question is absolutely correct.

There is a material difference between chassis shipments and line card shipments. And what you are seeing right now is us really seeding the footprint, the new footprint, that having an impact not on the European gross margin, so you are actually seeing a more depressed than typical European gross margin contribution. And you are also correct in that as those things get installed you'll start seeing line cards installed and you will start seeing that flow back up.

Michael Genovese - MKM Partners - Analyst

And then still on the gross margin, was there any warranty expense, was that a fourth issue in the quarter? Was there any warranty expense in the gross margin?

And I think you were asked this earlier but I just want to ask again. Price competition, has anything changed in terms of price competition in the market?



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

Nothing has changed in terms of price competition. If I look at the gross margin in the US as I mentioned before has been fairly consistent.

So we did have the services growing but here again that's accretive to our operating income. So no change in the competition. What was the first part of the question again?

Michael Genovese - MKM Partners - Analyst

Was there any warranty expense?

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

There was, of course, there was a warranty expense that Roger mentioned in his notes. We expect that will probably -- it will materially tail down is our hope from here. Now we only have some visibility to that, but we've got a chunk of that out of the way in the fourth quarter.

Michael Genovese - MKM Partners - Analyst

Just a couple more quick ones. Tier 1 G.fast timing, what part of 2017 should we think about that ramping up?

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

I wish I knew the answer to that. I don't know the answer to that. So we will start shipments.

Exactly how quickly they ramp up is somewhat out of our control. So I can't tell you if we will see a big ramp. More than likely what you typically see is as they start marketing the service you start seeing it take hold and then it hits an inflection point and really happens.

So I can't tell you exactly when that material pickup will happen. All we will be trying to do is making sure that we have the products integrated into their network and up and running and that we have the service available.

Michael Genovese - MKM Partners - Analyst

Great. And last one before I pass the mic, Tier 3 improvement in the fourth quarter, was that CAF II related or was any of that outside of CAF II?

Just any kind of comments on the overall rate of return carrier program for CAF II would be helpful. Thank you.

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

Sure. So I don't believe there was really CAF II impact.

You are correct and I mentioned it that we did see a pickup both year over year and sequentially and actually a pretty good pickup, if I look on a year-over-year basis a material pickup in the Tier 3 business. But I -- it doesn't feel like it's CAF II related. And the rationale for that is in November that was a trigger point where the carriers had to denote whether or not they were going to fall under the price cap carrier rules or the older rate of return rules.

That program was oversubscribed which is good. That program denotes them actually committing to building in underserved or non-served areas and having to show proof points along the way that they are actually building in those areas.

Many of the largest carriers actually signed up for that program. That gets finalized. I think the next go-round Roger is where they --

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

So they will be submitting a plan this week and then accepting at the end of March.

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

Okay. So the real impact for that group of carriers which are typically your largest Tier 3s won't happen until probably towards the end of this year.

Michael Genovese - MKM Partners - Analyst

Great, thank you, gentlemen.

Operator

Simon Leopold, Raymond James.

Victor Chiu - Raymond James & Associates - Analyst

Hi guys, this is Victor Chiu in for Simon Leopold. I just wanted to ask on the international growth, it seems you are expecting results will be heavily driven by that specific Tier 1 European carrier. But can you speak some about the opportunities outside of Europe and what possibility you have for growth in other regions and what the prospects are for other regions that you might be looking out for?

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

Yes, sure. First of all, there are multiple carriers in Europe. The largest one being the one that is doing the major vectoring rollout with us and we have the expanded footprint.

At the last count we had 108 G.fast trials. So our hope key there is converting those G.fast trials to revenue, and that's a big part of our plan.

Our largest traditional customer outside of Europe is in Latin America. There was effectively a freeze on capital spending with that customer in the second half of last year. That freeze has now been lifted, so we're comfortable -- well, we are feeling much more comfortable about seeing a meaningful contribution for that customer but not comfortable enough to really put it in our numbers.

And that's one where we had been working on GPON approvals, we had been working on Ethernet over copper approvals, we have been working on G.fast trials which are still going on. So there are a lot of things going on with that customer that we think will be very beneficial.

There is, of course, also a larger G.fast opportunity that is fairly well known in Australia that is still an ongoing thing that haven't quite landed yet. But we are feeling pretty good about it at this point.



Other than that, it's really that 108 trials. We do expect, by the way, that both in the US and Europe and probably even quicker in the US that there will be other customers coming on board for vectoring. So if you think about it, I had mentioned in my notes that we had shipped 10 million vectoring capable VDSL ports, that effectively driven by two major carriers.

So there is an awful large percentage of the carrier base that can now deliver 50 to 100 meg service. And most of the -- there aren't really any large carriers or Tier 2 carriers that aren't looking at figuring out how they could utilize that technology in the same way these other carriers have.

Victor Chiu - *Raymond James & Associates - Analyst*

Okay great. Thanks very much. That's helpful.

Operator

George Notter, Jefferies.

George Notter - *Jefferies & Company - Analyst*

Hi, thanks guys. I know there was a significant North American telco that was looking at an NG-PON2 deployment in a particular city. I guess I was just wondering if there was any update there.

I know you guys were in evaluations there. And I saw the press release also about interoperability of NG-PON2 products from the other day. I was just wondering if there is something we can read into that from you guys? Thanks.

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

I don't think I would read anything more to it than what it says, which is this is just part of that customer's evaluation process. We feel we are doing well. We think we are still a little way from a decision point.

As you know, you probably know, there are two competitors, us and one other competitor, in that RFP. So it's definitely a less crowded field. We are both, I think both parties are in there developing as quick as they can and trying to make sure that they are positioned well for whenever the award outcome will be.

We feel our technology is, now I'm biased in this, of course, but we feel our technology is the best technology. And we have some proof points as to why that is. But it's still an active going RFP where we have deliverables and we have calls pretty much every week.

George Notter - *Jefferies & Company - Analyst*

Got it. And then also just on the timing of that, does it still feel like that could be a revenue opportunity towards the end of this year in terms of when it could become material or how should we think about that?

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

Yes, George, I've always been, I would always be nervous, hopefully I haven't said that, I would not expect that this year. I think an award will be made this year. You may see some trial systems, but I think really to get it integrated up and running I think it will be difficult with where we are in the award process today.



Now I think when it was started off and the award was, and I don't know how much later the award is actually coming from what it was initially expected to be, but it's materially different. So I think it would be tough just because it's a big carrier.

George Notter - *Jefferies & Company - Analyst*

Thank you.

Operator

Rich Valera, Needham & Company.

Rich Valera - *Needham & Company - Analyst*

Thank you. I wanted to revisit the question of mix with your large German customer. You said currently you have, I think, a lot of greenfield footprint you are populating with chassis.

Presumably at some point this year that switches more towards an upgrade and a line card mix. Do you have any visibility to how that might trend through the year between chassis and line card with this big German customer?

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

A little bit. Not as much as you'd probably like. But the visibility we have is really reaching into the second quarter.

So we see that mix actually starting to shift in the second quarter. So we would expect, setting exchange rate aside, we would expect to see those margins improve sequentially throughout the year.

Rich Valera - *Needham & Company - Analyst*

Got it. And then as well with a warranty expense side, do we expect sequentially less impact from that?

I don't know how it was from 3Q to 4Q. I think it was a lessened impact, but can you talk about how you expect that to trend as we head into the first quarter and beyond on the gross margin?

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

Yes, it will be less if any in Q1. So hopefully we won't be talking about it in Q1.

But the way that we are modeling right now there's a little bit of impact to that, but hopefully we won't be talking about that in Q1. So it was less in Q4 than Q3 and our current projection is very little impact in Q1 and then no impact going past that.

Rich Valera - *Needham & Company - Analyst*

Got it. And then with respect to OpEx, you gave a baseline for Q1 that sounds like it's a bit down sequentially from Q4. Any other thoughts on how that OpEx level should trend as we move through the year?



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

There's always up and down based off of revenue and commission mix and things like that. Other than that I would expect OpEx to hold fairly flat. We are running a little hotter honestly than we want to because of the opportunity that was mentioned on NG-PON2 and us accelerating some of the development programs for that opportunity.

Other than that, and that's the biggest impact to our operating expense right now that we see next year that would -- I don't expect it to materially tick up, by the way, next year in that either. I think we are at a comfortable level. So other than the variability in revenue not a whole lot of change.

Rich Valera - Needham & Company - Analyst

Great. Just one final one for me.

You have had a vectoring program with a domestic Tier 1 customer that got off the ground I guess in 2016 and I think went out to a few cities and is expected to expand pretty significantly as we head into 2017. Have you started to see that ramp already in that big domestic vectoring program?

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

Let me just think about what I can talk about. We had good momentum coming out of the year with that program and we want to keep that momentum. And we are feeling pretty good about it right now.

I guess the answer to the question is yes. We feel good about where that program is going and the contribution for the full year as well as some contribution in Q1.

Rich Valera - Needham & Company - Analyst

And I gather that program has a significant service component to it. But in aggregate can you say if that business is corporate average gross margin or perhaps better than the European business?

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

So the problem is I am getting into a little bit of competitive situation here to the extent I talk about this. With where we are without a doubt it is better than our European business. We are very, we are happy with where we are right now in the US business.

Rich Valera - Needham & Company - Analyst

Got it. That's all for me. Thank you.

Operator

Tim Savageaux, Northland Capital.

Tim Savageaux - Northland Capital, Inc. - Analyst

Hi, good morning. A couple of quick questions.



First, you've commented I think on both Tier 2 and Tier 3 spending trends, I guess Tier 2 in part influenced by CAF. I wonder if you have any similar high-level commentary on US Tier 1 capital spending trends and whether indeed you saw anything in terms of a budget flush here in Q4 as I think some others have seen in the quarter?

And, secondly, and somewhat related I guess, given that you mentioned Q2, I did not, but with regard to Deutsche I wonder given what seems to be a stronger than seasonal pattern coming into your Q1 given the order strength you mentioned, is there any reason to believe that your normal double-digit sequential increase plus actually that you've seen in Q2 these last few years if not several would be different this year?

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

You are right, I didn't mention it, it is early to talk about. Right now, though, I don't see anything that would make us feel different about the seasonal pattern for the year.

We are coming into the year stronger. But if I look at the strength into Q1, it's very understandable and it's just where we are and where the customer base is and their mindset towards delivering the solutions that we happen to have. So I don't see anything that would make me feel different about seasonality at this point in time.

As far as pull-ins, I don't know of anything that was explicit that was a pull-in. I do know that there are some -- we saw an uptick in our European business which was unexpected. I don't think that was a pull-in, I think that was just a real need that they had.

And so I wouldn't characterize it that way. What happened in the US is very much planned, so I don't know of anything that I would explicitly call a pull-in. Although I will tell you, like I said, the order flow coming -- and a lot of that order flow turned into backlog, so the order flow coming into Q1 and exiting Q4 was just strong.

Tim Savageaux - Northland Capital, Inc. - Analyst

Well, thanks and congrats on a nice result (multiple speakers)

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

Thank you.

Operator

Bill Dezelle, Tieton Capital.

Bill Dezelle - Tieton Capital Management - Analyst

Thank you. A couple questions.

First of all, on a super simplistic level, do you expect your geographic footprint expansion project in Europe to be at risk at all in the first quarter associated with weather or is that really not an issue? And the second question is I believe you mentioned that vectoring is your fastest growing product in the history of the Company, and I'm curious if you can discuss why you've had that success relative to your competitive position and how we can think about that positioning going forward.



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

Sure. Weather typically does not affect our shipments into that customer. Some of this they tend to pre-position material and get ready, so I don't expect any impact because of weather barring something material different, but I don't expect it.

As far as the vectoring, first of all, you are right. And I think what happened is one of the things we did is we kept the focus on that product area. So I do think what we tried to do as vectoring capabilities were starting to come to fruition within the semiconductor area was make sure that we allocated enough resource to really get ahead of that curve.

And which was difficult, but I think it leads us to a point to where we say we have the most diversified portfolio of access products and I think that's correct. So I think we just kept our eye on it. I think there were a lot of people that thought copper technologies were dead and everything was going to go fiber quicker than it happened, or is happening or will happen is probably where we are.

I think there is a whole group of customers either because of capital budgets or because of their competitive situation or because of their geographic situation in relation to their network architecture that were very, very much willing customers for the technology. And I think it just happened to be where our R&D alignment was in relation to what they actually did.

Bill Dezellem - Tieton Capital Management - Analyst

And what's your current view of competitors' ability to catch up?

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

Right now we still feel pretty good. We have in the -- we have a broad product set and it's not easy to do, especially when you start getting into the outside plant category of products. So we are comfortable with where we are.

Then there are two offshoots to that. So super vectoring is coming right down the line. We will start shipping next year, and you are going to have a whole group of customers that are going to be looking at having super vectoring capability if they are going to go ahead and roll into vectoring, and that gives us what we think another leg up from a technology basis.

Then to some extent you will see G.fast be the next leg after that. So we are feeling good about that.

I think the other piece, if you look at the solution set which more and more people are looking at when they acquire the products, our Mosaic cloud-based architecture has really been a big benefit for us. Not so much in the initial vectoring shipments. That didn't get us to the 10 million, but that will get us to the 20 million.

So I think you've got to look at it as the entire set of solutions that you are actually offering. And right now we feel very good where we are situated.

Bill Dezellem - Tieton Capital Management - Analyst

Thank you, Tom.

Operator

Greg Mesniaeff, Drexel Hamilton.



Greg Mesniaeff - *Drexel Hamilton - Analyst*

Yes, Tom, as you look at your revenue mix, clearly Services & Support is becoming more center stage. What kind of cost levers do you have at your disposal to opportunistically improve gross margin in that revenue segment going forward?

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

That's a good question. The best thing we can do for gross margins right now is work on mix.

So there is mix within the gross margin segment. There are some areas in the services area that are fairly good gross margin. And then when you get into the actual installation and things it's not as good.

Last year was a building year for us. So I didn't expect our efficiency on either one of those areas to really be up to maximum or maybe -- I mean, when you are in a building area you tend to play catch-up a lot. And without a doubt we did that in 2016.

It was more important for us to make sure that we met the customers' requirement than whether or not we could save a couple of points of gross margin. And we will always make that trade-off towards meeting the requirement, but once you get your feet underneath you it's much easier to do both. So I think we will be more efficient.

We will definitely have more scale this year. We will have more scale both in personnel and more scale in revenues. So I think that efficiencies will come from that.

But the biggest thing is mix. I do want to make sure that you understand the picture, though, which is it is very accretive still to our opening income. So albeit the gross margin is low, and that's one of the things that you will see us shifting towards this year which is really talking more about operating income.

We will still talk about gross margin, but the gross margin on our services business I don't want people to think we don't want that to grow because we do. It is going to be negative on the gross margin line, but it is a very good business for us. But the best thing we can do right now is actually work on the mix, which means sell more of our higher-end services which we will be actively working on this year.

Greg Mesniaeff - *Drexel Hamilton - Analyst*

Thank you.

Operator

Rich Valera, Needham & Company.

Rich Valera - *Needham & Company - Analyst*

Thank you. I just wanted to clarify on the revenue guidance, the low single digit to mid-single digit, that was on a year-over-year basis, is that correct, Roger?

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

For guidance for Q1?



Rich Valera - *Needham & Company - Analyst*

Yes.

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

No, it's sequential.

Rich Valera - *Needham & Company - Analyst*

Sequential, okay, thank you. I appreciate that clarification.

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

At this point I think we are out of questions. So I appreciate everybody for joining us on our call. And we look forward to talking to you next quarter.

Operator

And this concludes today's call. You may disconnect at any time and have a wonderful day.

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