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# EDITED TRANSCRIPT

ADTN - Q1 2017 ADTRAN Inc Earnings Call

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**Thomas R. Stanton** *ADTRAN, Inc. - Chairman and CEO*

## CONFERENCE CALL PARTICIPANTS

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## PRESENTATION

### Operator

Ladies and gentlemen, thank you for standing by, and welcome to ADTRAN's First Quarter 2017 Earnings Release Conference Call. (Operator Instructions) During the course of the conference call, ADTRAN representatives expect to make forward-looking statements, which reflect management's best judgment, based on factors currently known.

However, these statements involve risks and uncertainties, including the successful development and market acceptance of core products, the degree of competition in the market for such products, the product and channel mix, component costs, manufacturing efficiencies and other risks detailed in our annual report on Form 10-K for the year ended December 31, 2016. 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 Tom Stanton, Chief Executive Officer of ADTRAN. Sir, please go ahead.

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**Thomas R. Stanton** - *ADTRAN, Inc. - Chairman and CEO*

Thank you, Robbie. Good morning, everyone. Thank you for joining us for our First Quarter 2017 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 first quarter results, and I will end with some comments of what we see on the future. Roger will then discuss our Q1 performance in more detail, and we will then open the call up for any questions that you may have.

As we stated in our earlier press release, revenues for the quarter were \$170.3 million, a first quarter record and up 20% over the first quarter last year. Our total Networking Solutions revenue, including both international and domestic markets, came in at \$143.6 million, overcoming our typical seasonal pattern, growing 13% sequentially and 16% year-over-year.



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Total Services & Support revenues came in at \$26.7 million, which is 46% ahead of the same period last year. Revenues for our domestic markets came in at \$119.3 million or 70% of the total, while our international revenues grew to \$51 million for the quarter or 30% of the total.

On a year-over-year basis, our domestic revenues increased 3% as demand for a higher bandwidth vectoring and fiber solutions accelerated from Tier 1 U.S. carriers and cable MSOs. We also saw continued growth in our Tier 3 business. We continue to be encouraged by the significant growth in our international business. International revenue grew 30% quarter-over-quarter and 97% over the same period last year, driven by increasing demand for our ultra-high speed solutions in Europe.

Moving down a little deeper, our Access and Aggregation category had a strong performance, up 28% over the same period last year, with growth both domestically and internationally. Customer Devices also saw strength during the quarter, up 12% over the same quarter last year and 16% ahead of last quarter, led by increasing demand for our fiber to the prem solutions to both Tier 1 carriers and MSOs.

Finally, our traditional and other product category was down 13% versus the same quarter last year due mainly to expected slowdowns in our older generation HDSL products, but up 16% compared to last quarter.

During the quarter, we continued to advance our position in next-generation access and software-defined networking solutions. In Q1, we announced the industry's first residential CORD implementation available in our award-winning Mosaic Cloud Platform. This implementation allows carriers to immediately leverage the benefits of software control and application modularity and the deployment of next-generation access networks.

This, when combined with our mobility access modules, allows carriers unprecedented flexibility in deploying networks today and will migrate to features, performance and requirements of tomorrow. We, of course, continue to move forward with our G.fast, our super-vectoring developments, as well as NG-PON2 and 10-gig PON developments for both the carrier and the MSO marketplaces. 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 and fiber access and ultra high-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 upgrade their infrastructures to meet customer demand.

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

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### **Roger D. Shannon** - ADTRAN, Inc. - CFO, SVP of Finance, Corporate Treasurer and Secretary

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

As Tom stated, ADTRAN's first quarter revenue was \$170.3 million, which is up 20% compared to \$142.2 million for quarter 1 of 2016, and up 4% from the \$163 million we reported last quarter.

Our Network Solutions revenues for the first quarter were \$143.6 million, up 16% from the \$123.9 million for quarter 1 of last year, and up 13% from the \$126.8 million reported for Q4 of 2016. This growth was led by the strength in our Tier 1 businesses, both domestic and international.

Our Service and Support segment continue a strong year-over-year growth as Q1 2017 revenues were \$26.7 million, up 46% compared to the \$18.3 million earned in quarter 1 of 2016, but seasonally down from the \$36.2 million reported for fourth quarter of 2016. Across our revenue categories, Access and Aggregation revenues for Q1 2017 were \$120.1 million, up 28% compared to \$93.9 million for quarter 1 of 2016, driven by significant growth in our European access business, and up slightly compared with the \$119.7 million look for quarter 4 of 2016.



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Customer Devices revenues for the quarter were \$36.3 million, up 12% compared to \$32.4 million for quarter 1 2016, and up 16% compared to \$31.4 million for quarter 4 2016.

Finally, traditional and other products revenues for quarter 1 2017 were \$13.9 million, down 13% compared to \$16 million for quarter 1 of last year, but up 16% compared to \$11.9 million for quarter 4 2016.

Looking at our revenues geographically. Domestic revenues for quarter 1 2017 were \$119.3 million, up \$3 million or 3% from \$116.3 million we reported in Q1 of last year, and down \$4.4 million or 4% from the \$123.7 million in quarter 4 2016.

Our international revenues for quarter 1 of 2017 were \$51 million, up 97% compared to \$25.9 million in quarter 1 of last year and up 30% from the \$39.3 million for quarter 4 of 2016. We published the reporting of each of these categories on our Investor Relations web page at [adtran.com](http://adtran.com).

For the quarter, we had 2 10% of revenue customers, 1 domestic and 1 international. Our GAAP gross margins for the first quarter of this year were 43.3% compared to 46.3% for the first quarter of 2016, and 43.4% last quarter. Our gross margin percentage was consistent with last quarter's results as the negative impact of the higher mix of international product revenues was offset by solid U.S. product revenues and lower domestic services revenues. The year-over-year decrease in our first quarter gross margins was primarily driven by higher international and domestic services revenues versus the same period last year.

Total operating expenses on a GAAP basis were \$66.7 million for Q1 of 2017 compared to \$60.3 million for quarter 1 of 2016, and \$66.5 million for quarter 4 in 2016. On a non-GAAP basis, our Q1 operating expenses were \$63.8 million compared to \$58.4 million in quarter 1 of last year and \$63.4 million last quarter.

The difference between GAAP versus non-GAAP OpEx in Q1 is due to amortization expenses associated with our Active EPON and RFoG product acquisition in the third quarter of last year and equity-based compensation. The year-over-year increase in OpEx was a result of customer-specific projects, performance-based compensation and the previously mentioned amortization of acquisition-related intangibles.

Operating income on a GAAP basis for the quarter just ended with \$7 million, up 27% as compared to the \$5.5 million reported in Q1 of last year and up 65% versus the \$4.3 million reported in quarter 4 of 2016. The increase in Q1 GAAP operating income as compared to Q4 is attributable to higher revenues, along with the consistent gross margin percentage and flat operating expenses.

The year-over-year increase in operating income is attributable to the significantly higher revenue, partially offset by the previously explained lower gross margin percentage and higher operating expenses. Non-GAAP operating income for quarter 1 2017 was \$10.1 million compared to \$7.5 million for both quarter 1 of last year and quarter 4 2016.

As described in our supplemental information provided in our operating results disclosure, stock-based compensation expense, net of tax, was \$1.5 million for quarter 1 of 2017 compared to \$1.3 million reported in quarter 1 of last year, and \$1.8 million in quarter 4 of last year. Expenses related to the amortization of acquired intangibles were \$713,000, net of tax, compared to \$287,000 in quarter 1 of last year and \$724,000 last quarter.

All other income, net of interest expense for quarter 1 of 2017, was \$1.3 million compared to \$2.6 million for both Q1 and Q4 of 2016. The sequential and year-over-year decrease in all other income is a result of lower investment gains in the quarter versus the comparable periods. As previously communicated, 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 1 of 2017 was an expense of \$1.7 million or an effective tax rate of 20.3% compared to a tax provision rate of 37.9% for quarter 1 of 2016 and a tax benefit of 10.6% for quarter 4 of 2016. The decrease in the tax rate versus Q1 of last year is primarily attributable to benefits recognized from foreign tax filings and a greater mix toward international revenue.

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As we discussed last quarter, Q4's tax benefit was the result of additional R&D credits recognized along with the expiration of statutes. Net income for quarter 1 2017 was \$6.7 million compared to \$5 million in quarter 1 of last year and \$7.6 million in quarter 4 of 2016. Non-GAAP net income for the first quarter of 2017 was \$8.9 million compared to \$6.6 million in quarter 1 2016 and \$10.1 million last quarter.

Earnings per share on a GAAP basis, assuming dilution for the first quarter of 2017, were \$0.14 per share compared to \$0.10 per share in quarter 1 of last year and \$0.16 per share for quarter 4 2016. Non-GAAP earnings per share for the first quarter of this year were \$0.18 compared to \$0.14 per share for quarter 1 of last year and \$0.21 for quarter 4 of last year. Non-GAAP earnings per share excluded the effect of amortization of acquired intangibles and stock compensation expense in each respective quarters. 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 \$112.8 million at the end of quarter 1, up from \$105.1 million last quarter. The increase in inventory is due to customer-specific projects and cost-saving bulk purchases. Net trade accounts receivable were \$85.4 million at quarter end, resulting in a DSO of 45 days compared to 43 days at the end of first quarter 2016, and 52 days at the end of Q4 2016.

The year-over-year DSO change was a result of higher international sales this quarter, and the sequential improvement was due to timing of shipments versus last quarter. Unrestricted cash and marketable securities, net of debt, totaled \$253.5 million at quarter end after paying \$4.4 million in dividends and repurchasing just over 259,000 shares of common stock for \$5.6 million during the quarter. For the quarter, ADTRAN produced \$9 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 second quarter 2017 revenues will be up in the mid to upper single-digits on a percentage basis versus first quarter of 2017. 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 would be flattish with the quarter just ended.

We're also expecting GAAP operating expenses for Q2 2017 to be up slightly due to customer-specific projects. Finally, we anticipate the consolidated tax rate for the second quarter to be in the low 30% range. We believe the significant factors impacting revenue and earnings realized in 2017 will be the following: macro spending environment for the carriers and enterprises; currency exchange rate movements; the variability of mix and revenues 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'll now turn the call back over to Tom.

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**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

Thanks, Roger. With that, Robbie, I think we're ready to open up for any questions that you may have.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) We can take our first question from Rod Hall with JPMorgan.

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**Ashwin Kesireddy** - JP Morgan Chase & Co, Research Division - Research Analyst

This is Ashwin on behalf of Rod. Based on your guidance for Q2, it looks like you are forecasting slightly slower seasonal growth in spite of strong commentary on ongoing broadband spending. I just wanted to juxtapose those 2 and see where we would be missing something. And also I want to touch on services gross margin. It looks like it was -- just Service and Support gross margin was only 25%, down materially from last year. Just wondering what's driving that.

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

So let me talk a little bit about the growth. I mean, the -- without a doubt, Q1 came in good, right, as far as just the booking rate. And we've -- I think we may have even mentioned for the Q4 booking rate for the end of Q4 was actually fairly strong, too. So we just saw that consistency carry through the quarter and actually build. So a little stronger than we had planned on. And I think with just the fact that we have a lot of project-related business that's going throughout the rest of this year, I think we're just trying to make sure that we're in a good position to be able to continue to meet our expectations. On a gross margin basis, I guess -- there's always a mix in gross margin. I'm not sure if that's something you want to touch on.

**Roger D. Shannon** - ADTRAN, Inc. - CFO, SVP of Finance, Corporate Treasurer and Secretary

Yes, so for quarter 1, we had kind of a continuation coming out at the end of last year of [NI] business and that mix in [NI] tends to be a little lower compared to what you sometimes typically think beginning the year where more engineering work happens. So just a carryover of projects continuing out of year-end.

**Ashwin Kesireddy** - JP Morgan Chase & Co, Research Division - Research Analyst

Okay. Can I ask about the (inaudible) project in the U.S.? Are you seeing any activity there? Can you update us a little bit?

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

Sure. So there's activity, of course. We have a Tier 1 buildout that's -- we have in outer region. In inner region, all of that is still on track, expecting to see some revenue before the half. The outer region, of course, is deploying first. And you probably, if you're tracking that from the customer side, you've seen where they've announced expansion in some of the cities that they're going to be rolling that product out initially. And then from the other customer basis, we are seeing absolutely the Tier 1 -- the other Tier 1 that has got a heavily copper-based process. Also looking at that at in the Tier 2s. But right now, our focus and the biggest activity is around the Tier 1 -- the large Tier 1 that we've already secured the award for.

**Operator**

We can take our next question from Michael Genovese.

**Michael Edward Genovese** - MKM Partners LLC, Research Division - MD and Senior Analyst

I just wanted to ask about the Tier 1 projects, with the -- not your big existing customer, but the other 2? And what the timing for each of those would be? Where we would expect to see revenue ramps?

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

Are you talking about the U.S. Tier 1s?



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**Michael Edward Genovese** - *MKM Partners LLC, Research Division - MD and Senior Analyst*

Yes, the U.S. Tier 1s.

**Thomas R. Stanton** - *ADTRAN, Inc. - Chairman and CEO*

Okay. So we expect -- so first, we have the one that is going on right now which is that we're seeing -- and I know you're not specifically asking about that, but we're seeing just very good positive momentum in that one customer, both from a PON basis and from a vectoring basis. The G.fast customer we expected to start and still expect to start seeing some shipments in the second quarter and then we will see that ramp. The big ramp will probably be towards the tail end of the year or next year. But that's just one of those that we really don't have good visibility too that kind of -- they tend to be flexible in the way that they forecast and schedule things. The other one, which is an NG-PON2 RFP is probably one -- the one that you're touching on. We have been and still expect to see an award this year. But we don't see -- expect to see material rollouts until next year.

**Operator**

We can take our next question from Doug Clark with Goldman Sachs.

**Douglas Clark** - *Goldman Sachs Group Inc., Research Division - Research Analyst*

My first one is on services. Obviously, saw it come down quarter-on-quarter in the first quarter. I'm wondering if throughout the rest of the year, you expect services do pick back up as a percentage of revenue? If there's something else going on where that might trail off?

**Thomas R. Stanton** - *ADTRAN, Inc. - Chairman and CEO*

No, I would expect it to pick up. You may -- the fourth quarter is probably the one that's going to be the -- it's the one that's less sure. And it just depends on how much we get done before the fourth quarter. The majority of the services we have, our customers want them in as fast as we can do it. So the biggest reason Q1 is down is it's a matter of ramping up after Christmas and after the weather breaks. Because there are some areas, especially up in the North, Midwest and Northern regions where you just really can't do a whole lot until winter kind of subsides. So that's expected and then you'll see us ramp through the rest of this year. I would expect fourth quarter to be very strong, too, just because we tend to try to really close out jobs. But a lot of that is going to be weather-dependent.

**Douglas Clark** - *Goldman Sachs Group Inc., Research Division - Research Analyst*

Okay, that's helpful. And then internationally, obviously up very nicely sequentially and it sounds like marginally driven by the major carrier in Germany there. Can you talk about the visibility that you have for them throughout the rest of the year? And do you expect a similar pattern to prior years, which was strong first half and then kind of down in the second half?

**Thomas R. Stanton** - *ADTRAN, Inc. - Chairman and CEO*

That's what I would expect right now. It nearly surprised us last year. But right now, I would expect that you would see the European business actually tail off in the second half of the year. And you'd see the -- we'd see a stronger (inaudible).



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**Douglas Clark** - *Goldman Sachs Group Inc., Research Division - Research Analyst*

Okay, perfect. And then final question, actually on U.S. Can you just kind of characterize or level set us on how the spending environment in the U.S., either by Tier 1, 2 or 3, kind of progressed throughout the beginning of the year meaning where budgets released kind of on time or as expected or were -- was there a little bit of earlier than expected or later?

**Thomas R. Stanton** - *ADTRAN, Inc. - Chairman and CEO*

Tier 1 was earlier. Tier 2 and 3 about what you typically see. So -- and in fact, I would probably even say that Tier 2s are probably a little slower than we typically see. But without a doubt, the Tier 1 business that we have was kind of locked and loaded and it came out of the gate pretty strong.

**Operator**

We can take our next question from George Notter with Jefferies.

**George Charles Notter** - *Jefferies LLC, Research Division - MD and Equity Research Analyst*

I guess I wanted to just ask about the gross margin outlook for the balance of the year. Obviously, you gave us a sense for the guide for Q2. But I was thinking more about the second half. And I think if I go back to last quarter, you guys had suggested that we could see margins kind of come back into the mid- and high 40s as the year progresses. Is that still kind of consistent with how you're looking at the back of the year at this point 3 months later?

**Thomas R. Stanton** - *ADTRAN, Inc. - Chairman and CEO*

Yes, it still is. I don't know how high into those 40s, George, that we're talking about. But mid- to high 40s, I think, is -- that's still what we're talking about. So let's say, we're expecting it to be -- I don't want to get too granular here, but your comment is correct.

**George Charles Notter** - *Jefferies LLC, Research Division - MD and Equity Research Analyst*

Okay, got it. And then obviously the drivers then would be a lower mix of business -- Tier 1 business in Europe ramping line card sales in the U.S. And then the offset would be a higher mix of services would give you that -- a negative pressure there.

**Thomas R. Stanton** - *ADTRAN, Inc. - Chairman and CEO*

That's correct. That's correct. It's really -- the way I really think about line card versus non-line card business in the U.S. is really U.S. versus European versus services. Those are the 3 components.

**George Charles Notter** - *Jefferies LLC, Research Division - MD and Equity Research Analyst*

Okay. And then how is warranty expense figure in here? I know that you guys are expecting another warranty accrual to kind of roll off here in Q1. Did that indeed happen? And then how do you think about that over the balance of the year?

**Thomas R. Stanton** - *ADTRAN, Inc. - Chairman and CEO*

It did. It definitely got better. I don't see it being a material impact to us going forward. I think we've kind of gotten through that portion there. There's still some cleanup that we have to do, but I won't expect that to materially change things.



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### Operator

And we can take our next question from Greg Mesniaeff with Drexel Hamilton.

### Gregory Mesniaeff - Drexel Hamilton, LLC, Research Division - Senior Equity Research Analyst

Question on the OpEx trends that we've seen recently. Tom, you mentioned last quarter on the earnings call that OpEx was running quite a little hot. And just earlier today, Roger guided to OpEx being essentially consistent with Q1 or maybe even a little higher. I was wondering what you guys are thinking about in terms of where your target really is for OpEx levels? And how you expect to manage that?

### Thomas R. Stanton - ADTRAN, Inc. - Chairman and CEO

Yes. We have a long-term target and a near-term target. And without a doubt, you're pointing at something that's correct which is we're a little -- we're hotter on the OpEx than I would like to be. If I look at the driver of that, it's very easy to see and it's very much in our engineering, our R&D budget. And it is -- I don't want to say exclusively but predominantly by far, driven by some accelerations that we have for a Tier 1 customer here in the U.S. that has a positive impact on other Tier 1s, on both in the U.S. and outside of the U.S. And so we'll see some benefit from that. But it is predominantly driven by an RFP in the U.S. where they've got some accelerated -- in fact, recently accelerated milestones that we're having to make sure that we actually hit the mark on. So that's what's driving it. And when that is over, we have this set up in a way to where most of this, if not all of this, higher-than-anticipated or higher than wanting a level we can actually bring down in fairly short order after we finish those developments.

### Operator

And we can take our next question from Simon Leopold with Raymond James.

### Simon Matthew Leopold - Raymond James & Associates, Inc., Research Division - Research Analyst

A couple of things I wanted to make sure I understood here. One is in terms of the business with the Tier 1 in Europe. I think in the past, you've indicated that -- you had an incremental opportunity not just to sell network here but to work with them selling, I guess, what you now call customer devices. I just wanted to make sure I was up-to-date given the strength in -- relative strength in the customer device business in this quarter. I want to see if we can associate those 2 projects or that segment with the European-German project? Is that correct?

### Thomas R. Stanton - ADTRAN, Inc. - Chairman and CEO

Yes, Simon. First, you have a good memory. And yes, that opportunity is there. That opportunity, by the way, is still alive. It is -- and in fact, it has been increased in priority within that carrier. Just recently, it's been kind of reiterated to us. But that opportunity is not shipping materially today. So that is something that is still out in front of us. As of the last time we spoke to them specifically about this was probably 1.5 months ago, and it is very high on their priority list. They see our products had been the only one that gets them to market with the service that they feel they have to have. But it is a solid 1.5 years to 2 years late. But that did not affect the number for Q1.

### Simon Matthew Leopold - Raymond James & Associates, Inc., Research Division - Research Analyst

So that's good news and then it's dry powder. So then what was the source of strength for the Customer Devices in the March quarter?



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**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

Well, we saw strength -- I had mentioned PON as being one of those areas and drivers. But we saw fairly good strength across the board. If you think about what's in our Customer Devices, it's routers and switches, but we have -- not only did we see strength in the PON business, but we also, of course, have the acquired RFOG business, which was beneficial as well.

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

Okay. And then in terms of your international business, obviously, it's been very strong. We know about Germany. So you haven't broken out Germany as a region. I assume in the 10-K, if Germany is over 10%, you would break it out. Could you give us some indication of what percentage of your business was specifically Germany in the March quarter?

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

It was -- let me just say it was the predominant piece of the European business.

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

Great. And then just one last one. In terms of kind of a bigger picture trend. And I am in print with some skepticism about 5G, so I'll preface with that. But if you could comment on your thoughts about the coming 5G builds, particularly in light of some of the commentary from Verizon just the other day about deploying fiber in order to enable a 5G network. But it seems like it would bode negatively for your products and your strategy. But if you could talk to how you think about that playing out over the coming years.

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

I don't think -- but first of all, I agree with, I think, your sentiment which is where 5G is going to be used and what it's going to be used for is still debatable. Then there's another debate as to when does it get deployed in a material fashion. Or is that -- do we see kind of pre-standard deployment or do we see post-2020 deployment where it really happens. But in all of those cases, I see fiber access as being a fundamental component because of the bandwidth required and the number of endpoints actually envisioned being terminated. That carrier that you mentioned, of course, is also driving an NG-PON2 RFP process, which is an integral part of -- at least in my mind, so I do want to speak for them, of their mobility strategy. And I -- if you'll notice, I mentioned in my comments, our mobility access capabilities that we have added to while our Mosaic Cloud Platform, specifically to address mobility and the future implementation of 5G. So I think that it's actually -- that they're very much additive to each other and complementary. And the thought of deploying hundreds of thousands of 5G RF head-ends or RF devices is a good thought in my mind.

**Operator**

And we can take our next question from Rich Valera with Needham & Company.

**Richard Frank Valera** - Needham & Company, LLC, Research Division - Senior Analyst of Communications Infrastructure, Technical Software and Communications Services

First question, just on the expected margin trajectory with your large German customer. I thought last quarter you'd mentioned that you expected the first quarter to be kind of a trough there as you shift in sort of non-channel -- I'm sorry, non-channel card shipments in there. And then you expect it to sort of ramp presumably in 2Q and beyond. So I just wanted to see if that's still kind of what you're thinking in terms of that (inaudible).



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**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

That is still what we're thinking. Gross margins were probably a little bit higher in Q1 than we probably would have explicitly stated, but that is still what we're thinking. There was more line card shipments that we ultimately delivered in Q1 to that customer, but your thought process is correct.

**Richard Frank Valera** - Needham & Company, LLC, Research Division - Senior Analyst of Communications Infrastructure, Technical Software and Communications Services

Got it. And then there's been no mention of your other international, I guess, Tier 1 in Mexico. I know there's been -- things have been kind of on hold down there. Can you talk about the status of the couple of projects you've had sort of going through lab trials there? And if you think there'll be any contribution from them this year?

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

The status of the -- let me just say, the regulatory environment in Mexico in my opinion has not gotten better. There was a point in time, let's say, 6 months ago, where it was heading towards closure and we could actually -- we were under the belief that things would lighten up. They seem to be moving towards a much more regulated environment at this point where they are likely to spin-off the fixed assets into a separate entity and that has caused let me just say a lot of confusion with that customer. So all of -- there's not a thing that we are doing that has stopped as far as approvals and everything. But as far as that customer getting into a position where they're going to actually kind of release capital and start spending again, I still think that that's the time (inaudible).

**Richard Frank Valera** - Needham & Company, LLC, Research Division - Senior Analyst of Communications Infrastructure, Technical Software and Communications Services

So is it fair to say you're not expecting significant contribution from them this year? I mean, what are your expectations for that...

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

We have not forecasted. And honestly, even coming into the year, we didn't even forecast a lot because of just the uncertainty. So -- and our plan does not have a lot of sales to that customer.

**Richard Frank Valera** - Needham & Company, LLC, Research Division - Senior Analyst of Communications Infrastructure, Technical Software and Communications Services

Got you. And one more. Just with -- in North America, you've been involved in a vectoring program, which started last year with one of your large customers. It was expected to ramp pretty significantly this year. Can you give us any color on how that program is looking for the year?

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

Are you talking about a Tier 1 customer here in the U.S.?

**Richard Frank Valera** - Needham & Company, LLC, Research Division - Senior Analyst of Communications Infrastructure, Technical Software and Communications Services

Tier 1 customer in the U.S., yes.



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**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

Okay. So we've got a couple, right? So we have one which is very, very vectoring-focused. And that one is pretty much right on plan, and we would expect that to continue on over the next 3 years or so. And then the other one, we expect to start seeing some shipments. In fact, depending on how you (inaudible), you could say we have seen some, but we'll start seeing some shipments in the first half. And then you'll see that ramp up from that point forward.

**Operator**

And we can take our next question from Bill Dezellem with Tieton Capital Management.

**William J. Dezellem** - Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer

That's Tieton Capital. A group of questions. First of all, I'd like to start with the timing of the Tier 1 R&D project ending that you've mentioned was important that was causing your expenses to be inflated. When do you anticipate that's going to end?

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

Good question. I think the question is, at least from my perspective is -- well, it's difficult to answer because of the fact that the requirements have changed. So I would have expected it to end in Q1, at least the materially incremental piece, in Q1. Until now, we're standing to the changes in the requirements that hit us out. At this point in time, I don't see that ramping down before Q3 really.

**William J. Dezellem** - Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer

Okay, so that answers the financial question. What are the business implications of that for ADTRAN, both this year and over the coming years?

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

So there's the one opportunity itself and it's -- and as you're aware, it's a large opportunity which has implications not just for the fixed capabilities but also for the wireless capabilities as I spoke to with Simon's question. So there is that piece itself. But I would tell you the functionality we're implementing both for mobility and for virtualized core functions that are in areas that we were not playing in before is very positive to us, and not just for that customer. In the sense of the virtualization of kind of some of the routing functions and some of the things that we're doing specifically for that customer, there's a market waiting outside of just that one customer. And there's not a single customer that we have spoken to -- I think literally, I haven't spoken to all of the customers. But all of the feedback I have gotten on the implications of that feature being rolled out to the larger market had been positive. So I think it is a direction where we want to go. We're just doing it in an accelerated fashion.

**William J. Dezellem** - Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer

That's helpful. And then a couple of additional questions. First of all, the service margin was down but on higher revenues. Clearly, there's something going on there that I don't fully grasp. Could you shed some insight? And then secondarily, what are the implications of the Vocus release that came out here earlier this month.

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

That's a good question. Well Vocus, first of all, is yet another Mosaic customer. So we continue to see traction on Mosaic, especially if you think about how early that is in the lifecycle of the product. And for those of you who don't know, Mosaic is our orchestration SDN software that's used to manage infrastructure in the kind of a next-generation router. So that was very positive. It's not -- as you know, there are other customers in that



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region, one specific customer which has a process that's been elongated for some period of time. I will say we have also signed a contract with that customer as a Mosaic customer as well. And that is a large Tier 1 in the (inaudible) area. So just the positive momentum we're getting there has been very good. And then the second piece to your question was, again...

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**Roger D. Shannon** - ADTRAN, Inc. - CFO, SVP of Finance, Corporate Treasurer and Secretary Services.

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**William J. Dezellem** - Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer Service margin.

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**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

Oh, on services. The only big difference versus where we would have saw last year, typically, you'll see Q1 have higher gross margins because the engineering work is typically done in Q1 and then you see them roll out. I think the difference this year is we had more activity in Q4 that basically just bridged over into the next year. So we did more installation jobs than we initially expected to do. So we still have engineering jobs that we're doing. But you saw that being diluted by the heavier-than-expected installation jobs ourselves as we closed out stuff from 2017 -- or 2016.

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**Operator**

We can take our next question from Paul Silverstein with Cowen.

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**Paul Jonas Silverstein** - Cowen and Company, LLC, Research Division - MD and Senior Research Analyst

If I could take you back to an earlier question, I appreciate how hard it is to forecast given the quarter out. With that said, looking into the future, any thoughts on what you can do in terms of gross margin and what the peak margin level is. And I appreciate that there are different levers in terms of U.S., non-U.S. services products. But working the model, working against it from a peak perspective. Any thoughts on that?

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**Roger D. Shannon** - ADTRAN, Inc. - CFO, SVP of Finance, Corporate Treasurer and Secretary

I would agree with what Tom said a few minutes ago. It's -- and I'd certainly agree with your point on the difficulty of projecting out past the current quarter just given the nature and the timing of the book and ship on it. But it's -- what our expectations are is kind of to return to the mid to upper 40% range. That -- last quarter, you'll recall we had kind of a surprise upside in international. But that had a -- which typically would have a dilutive effect, but that had a positive mixed component to it. So we even had a positive impact overall. We've talked all along that we expected first quarter to be down, and it was because of the mix of international and it being -- beginning the shipments of the Greenfield project and the equipment associated with that. I think all I can say is our -- at this point in time is our expectations are that the gross margins will increase and our goal and our expectation is that mid- to upper 40% range.

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**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

And to just to add color to that (inaudible) you got to be careful with that. But from what we can see today in the mix of the business we have today with no -- take into account the seasonality, the 46% - 47% range seems to be a rational number for us to able to get to.



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**Paul Jonas Silverstein** - Cowen and Company, LLC, Research Division - MD and Senior Research Analyst

Well, and follow for me, beyond this year, is there -- I assume you guys are allowing for meaningful growth from the service piece of business in the offsets on the software side. Is that the way to think about it in terms of the key levers?

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

Would you state that, again, please?

**Paul Jonas Silverstein** - Cowen and Company, LLC, Research Division - MD and Senior Research Analyst

I assume your services are going to continue to grow (inaudible) business, right? And that's going to have a dilutive effect. I assume also to some extent, as your Mosaic software, which I assume have higher -- significantly higher margin. Was that the offset from the services piece?

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

I think it's that piece, too. But I also think that we have some product-specific business for us in G.fast that has a very smaller services component. And without a doubt, the gross margin on that will be positive. So that's probably a near-term driver than the aggregate software revenue impacting us as far as for the near-term.

**Roger D. Shannon** - ADTRAN, Inc. - CFO, SVP of Finance, Corporate Treasurer and Secretary

And I would add that we've said all along and continue to say that while services is dilutive in gross margin level, it's accretive in the operating income level, we continue to monitor that and believe that. We've also stated and continue to reiterate that our services business has scaled rapidly, and we certainly see opportunities as to improve gross margins through efficiencies and we're actively working...

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

I think that, that is a good point. It is much more difficult to optimize when you're growing as fast as we're growing. And we are putting things in place where this year, I think you'll start seeing us drive more efficiency out of that.

**Operator**

We could take our next question from Tim Savageaux with Northland Capital.

**Timothy Paul Savageaux** - Northland Capital Markets, Research Division - MD and Senior Research Analyst

Couple of questions. One just very quick and one maybe broader in focus. First on the tax rate, sort been lower-than-expected. These last few quarters guided to around the 30% range for Q2. I wonder if you expect that level to maintain throughout the year? If you have any comments on outlook for tax rate throughout the year? Second, and broader question is maybe to relate some of the commentary you've had about NG-PON2 RFP activity with the pretty interesting announcement yesterday from Verizon and Corning with regard to \$1 billion purchase commitment over 3 years for optical fiber. And whether that might provide us with an opportunity to try and size the equipment opportunity that you might be facing a Tier 1 carrier such as that feel free to say it's plus or minus \$300 million a year or -- in general, if you don't want to be that specific, maybe talk to how you perceive that move on Verizon's part to kind of secure fiber supply that far out relative to the opportunity you might be facing in access infrastructure.



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**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

Right, so that is a good question. And just because our history is trying to peg revenue numbers down is very difficult. But I do think that at least from our view, the commitment that, that customer is showing towards deploying their next-generation fiber network has been getting stronger every month. Very rarely do you see us materially change our OpEx over a long period of time for any customer. We're usually able to manage that within the normal operating model that we're trying to run under at any given time. And the reason we're doing that here is twofold. One is, we really do believe that the opportunity is large and we believe that the opportunity is long term and sustainable over multiple of the years. And two, we think it's very much aligned with what customer requirements will be going forward. And I'm really not specifically speaking just about the NG-PON2 component because the NG-PON2 component, although it's hard and it drives some R&D effort by itself, it's really the whole back-end with Mosaic on top of the rack data center implementation that's very complex and very much where people wanted to go. And the acceleration of that is something that we're very much willing to do because we do think it'll pay you longer-term dividends. But directly to your point, I think that, that commitment is -- that you read about is in line with the feeling that we have about that opportunity.

**Roger D. Shannon** - ADTRAN, Inc. - CFO, SVP of Finance, Corporate Treasurer and Secretary

I'll address your question on the tax rate. Our guidance on Q2 being in the low 30s kind of recognizes in the international mix. As Tom said just a few minutes ago to a previous question, we expect that normal shift in international mix down in the back half of the year to happen again. And that would put some upward pressure on the tax rate. So we see it notwithstanding any changes to the U.S. tax structure that may or may not happen this year. It will have a slight drift back up over the course of the year.

**Operator**

We can take our next question from Fahad Najam with Cowen.

**Fahad Najam** - Cowen and Company, LLC, Research Division - Associate

Just a question on -- if you look at the broader tax strategy under the new administration. And if I'm not mistaken, you have manufacturing facilities in Mexico. How should we be thinking about that as an impact? Have you factored that into this year? Can you provide some commentary there?

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

I don't think we're -- we're in a position right now, as you may have realized, we have manufacturing facilities in Asia, in Europe and here in the U.S. as well as in Mexico. And I think one of the things that we've done a very good job over the last 4 to 5 months or so has been getting ourselves into a very flexible situation to where we can maximize what other benefits we need, too. Any comment on that -- other comment on that, Roger?

**Roger D. Shannon** - ADTRAN, Inc. - CFO, SVP of Finance, Corporate Treasurer and Secretary

No. And again, I assume you're talking about any border adjustment policies. And I believe it's way too early to speculate on that. There was more talk about border adjustment early on, I think more that's been thought about. You're hearing less about, but certainly we just got to wait and see. But to Tom's point, we think we're in a good position with our global distribution and manufacturing capabilities to be very flexible to do what we need to do.



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**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

I think we only do what we do, but I think we may be able to actually maximize -- we actually could see some benefit just because of the flexibility that we have and we're kind of uniquely positioned. We do not see many people in our space that actually have manufacturing in the U.S. And that's one thing that we've -- that has been kind of a differentiator for us for a period of time.

**Fahad Najam** - Cowen and Company, LLC, Research Division - Associate

Okay. So just to be clear on the -- if you were to build or manufacture in the U.S. for, say, the CAF II in the U.S. deployments, would that be a meaningful implication in margin? Is that a headwind? Would it be (inaudible) estimate of percentage point headwind if you source all your manufacturing in the U.S.?

**Thomas R. Stanton** - ADTRAN, Inc. - Chairman and CEO

I sourced all my manufacturing in the U.S. because my margins would go up and because there would be some clause that would actually allow me to benefit for it or I wouldn't do it.

All right. I think that covers our questions. So I appreciate everybody for joining us for the conference call today. And we look forward to talking to you in the next quarter.

**Operator**

This does conclude today's program. Thank you for your participation. You may now disconnect.

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