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ADTN - Q1 2018 ADTRAN Inc Earnings Call

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APRIL 18, 2018 / 2:30PM, ADTN - Q1 2018 ADTRAN Inc Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to ADTRAN's First Quarter 2018 Earnings Release Conference Call. (Operator Instructions)

During the course of the conference call, ADTRAN representatives expect to make forward-looking statements, which reflect management's best judgment based on factors currently known. However, these statements involve risks and uncertainties, including the successful development and market acceptance of core products, the degree of competition in the market for such products, the product and channel mix, component cost, manufacturing efficiencies and other risks detailed in the annual report on Form 10-K for the year ended December 31, 2017. These risks and uncertainties could cause actual results to differ materially from those in the forward-looking statements, which may be made during the call.

It is now my pleasure to turn the call over to Mr. Tom Stanton, Chief Executive Officer of ADTRAN. Sir, please go ahead.

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

Thank you, Lynn. Good morning, everyone. Thank you for joining us for our first quarter 2018 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 on what we anticipate going forward. Roger will then discuss our quarter 1 performance in more detail, and we'll then open the call up for any questions that you may have.

Revenues for the quarter were \$120.8 million and our Network Solutions revenue, including both international and domestic markets, came in at \$105.3 million. Total Services & Support revenues for the quarter were \$15.6 million, with revenue in our domestic markets total coming in at \$62.1 million or 51% of the total; and our international revenues coming in at \$58.7 million or 49% of the total.

On a year-over-year basis, our domestic revenues decreased 48% due to merger-related spending pause at a Tier 1 operator. And our international business increased 15% year-over-year, with a seasonally stronger European Tier 1 spending. As expected, our performance this quarter continue to be impacted by a merger-related review and slowdown in the spending at a domestic Tier 1 customer.



APRIL 18, 2018 / 2:30PM, ADTN - Q1 2018 ADTRAN Inc Earnings Call

While our international revenue exceeded expectations, lower overall product volumes resulting from the domestic slowdown and lower international gross margins associated with footprint expansion for super-vectoring, negatively affected our profit margins for the quarter and further hampered our results. However, looking ahead, we expect to see continued strength in our European business in the second quarter and growth in our North American business in the second half of this year.

During the second quarter, we expect to gain further clarity around the domestic Tier 1 account, post-merger business outlook. And we expect to see strengthening of the domestic regional service provider market, particularly in fiber optic access. To that end, in the first quarter, we were awarded a major broadband RFP from a large domestic Tier 1 operator, which solidifies our primary market share position in that segment. In the domestic rural broadband market, ADTRAN added 9 new accounts to the Fiber-to-the-Premises and gigabit network buildout, and we're awarded a turnkey services contract with another major Tier 2 operator in the U.S.

These milestone achievements are good indicators of our continued momentum and aligned with our strategic objectives to grow and diversify our services business and to expand our portfolio toward all types of providers, including cable MSOs, telecoms, electric coops, utilities, municipalities and others.

I want to provide an update on the new Tier 1 opportunities that we have discussed previously. All are moving forward with major milestones completed, and others are approaching us near term. In the domestic Tier 1 Mosaic and G.fast project, we completed the out-of-region launch last quarter and are wrapping up the in-region launch right now. These launches include the integration phase for this project and have enabled customer service availability within any markets where they are deploying MDUs nationwide.

For our NG-PON2 project, we continue to invest heavily and are completing key milestones for the overall solution as our engagement with the customer is now at a peak level. I expect to be able to share more with you on this project in the upcoming call.

In Australia, we have received purchase orders and now expect the nationwide production ramp of our G.fast rollout to begin in the second half of the year. This is one of several contributors to our positive outlook in the second half.

In Europe, a leading Tier 1 operator awarded us additional market share for business CPE, and we made significant progress with a new European Tier 1, where we finalized the master purchase agreement and successfully completed the second round of Mosaic 10-gig PON lab trials. We now have clearance for a field trial. Additionally, ADTRAN is making strong progress with network implementation services projects in the Tier 1 and Tier 2 European market.

In alignment with our strategic plans to diversify our customer base and grow our positions in the cable MSO market, we announced during the quarter the acquisition of the dominant EPON portfolio manufacturer in the North American market. These EPON solutions, coupled with our existing portfolios, strengthens our incumbent position with the leading cable and MSO operators here in the U.S.

While a slowdown of a domestic Tier 1 customer, coupled with the timing of new major projects, have provided near-term challenges. We are seeing progress that we believe will have a positive and meaningful revenue contribution in the second half of the year and will feel strong momentum in 2019.

ADTRAN continues to be at the forefront of software-defined access, and we are well-positioned to help service providers who seek transformation to grow revenue, reduce cost and accelerate service delivery and deployment.

With that, I'd turn it over to Roger to add some more comments on the Q1 results.

Roger D. Shannon - ADTRAN, Inc. - CFO, Senior VP of Finance, Corporate Secretary & Treasurer

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.



APRIL 18, 2018 / 2:30PM, ADTN - Q1 2018 ADTRAN Inc Earnings Call

As Tom stated, ADTRAN's first quarter revenue came in at \$120.8 million compared to \$170.3 million for quarter 1 of last year and \$126.8 million we reported last quarter. Our Network Solutions revenues for the first quarter were \$105.3 million versus the \$143.6 million for quarter 1 of last year and \$95.8 million reported for quarter 4 of 2017.

Our Global Services & Support revenues in quarter 1 2018 were \$15.6 million compared to the \$26.7 million earned in quarter 1 of 2017 and \$31 million reported for fourth quarter of 2017. Across our revenue categories, access and aggregation revenues for quarter 1 2018 were \$81.7 million compared to \$120.1 million for quarter 1 in 2017 and \$79.2 million last quarter.

Customer devices revenues for the quarter were \$30.1 million versus \$36.3 million for quarter 1 of 2017 and \$32.8 million for quarter 4 of last year. Traditional & Other Products revenues for quarter 1 2018 were \$9 million compared to \$13.9 million for quarter 1 in 2017 and \$14.9 million for quarter 4 2017.

Looking at revenues geographically. Domestic revenues for quarter 1 2018 were \$62.1 million versus the \$119.3 million we reported in quarter 1 of last year and \$94.3 million in quarter 4 2017. Our international revenues for quarter 1 2018 were \$58.7 million, up compared to the \$51 million in quarter 1 of last year and up from \$32.5 million for quarter 4 2017. We have published the reporting of each of these categories on our Investor Relations web page at adtran.com.

For the quarter, we had 2 10% of revenue customers. Our GAAP gross margins for the first quarter of this year were 32.9% compared to the 43.3% for first quarter of 2017 and 46.4% last quarter. The year-over-year and quarter-over-quarter decreases in our gross margins were driven primarily by the increased waiting of our international business, coupled with an increase in lower-margin starter kits associated with footprint expansion in the European Tier 1 customer, unfavorable mix in our domestic services business and \$2.4 million of restructuring expense.

Total operating expenses on a GAAP basis were \$66.4 million for quarter 1 of 2018, a decrease of \$400,000 compared to \$66.8 million for quarter 1 of 2017 and \$3.4 million higher than the \$63 million reported in quarter 4 of 2017. On a non-GAAP basis, our quarter 1 operating expenses were \$60.6 million compared to \$63.9 million in quarter 1 of last year and \$60.7 million last quarter.

The year-over-year decrease in operating expenses is primarily attributable to lower performance in equity-based compensation in the quarter, lower R&D expenses related to customer-specific projects and reduced intangible amortization related to acquisitions, all of which more than offset the \$3.6 million of restructuring expenses and OpEx. The quarter-over-quarter increase in operating expenses was primarily the result of the previously mentioned restructuring expenses, increase in performance in equity-based compensation and foreign exchange movements, offset by lower R&D expenses.

The difference between GAAP results and non-GAAP operating expenses in Q1 is due to restructuring expenses associated with our early retirement program, amortization expenses related to our Active EPON and RFoG products acquisitions in the third quarter of 2016 and equity-based compensation.

Operating income on a GAAP basis for the quarter just ended was a loss of \$26.6 million compared to operating income of \$6.9 million reported in quarter 1 of last year and an operating loss of \$4.2 million reported in quarter 4 of 2017. The decrease in quarter 1 GAAP operating income, as compared to quarter 1 2017, is attributable to lower revenues with unfavorable mix, offset slightly by favorable foreign exchange movements and lower operating expenses. The quarter-over-quarter decrease in operating income is driven primarily by lower revenues with unfavorable mix and higher operating expenses.

Non-GAAP operating income or adjusted EBIT for quarter 1 of 2018 was a loss of \$18.3 million compared to income of \$10 million for quarter 1 of last year and a \$1.8 million loss reported in quarter 4 of 2017. As described in the supplemental information provided in our operating results disclosure, stock-based compensation expense, net of tax, was \$1.4 million for quarter 1 of 2018 compared to \$1.5 million reported in quarter 1 of last year and \$1.4 million last quarter. Expenses related to the amortization of acquired intangibles were \$427,000, net of tax, compared to \$713,000 in quarter 1 of last year and \$297,000 last quarter. Restructuring expense, net of tax, was \$4.4 million for the first quarter of 2018 compared to 0 reported in quarter 1 of last year and \$36,000 last quarter.



APRIL 18, 2018 / 2:30PM, ADTN - Q1 2018 ADTRAN Inc Earnings Call

All other income, net of interest expense for quarter 1 of 2018, was \$14 million, inclusive of an \$11.3 million bargain purchase gain compared to \$1.4 million for quarter 1 of 2017 and \$3.4 million last quarter. The bargain purchase gain, associated with the acquisition of North American EPON assets from Sumitomo Electric, represents an estimate of the excess fair value of net assets required as compared to the consideration exchange.

The company's tax provision for quarter 1 2018 was a tax benefit of \$3.5 million or an effective tax rate of 27.8% as compared to a tax expense of \$1.7 million or 20.3% in quarter 1 of 2017 and a fourth quarter 2017 tax expense of \$10.4 million, which included an \$11.9 million write-down of deferred tax assets and the deemed repatriation tax on our accumulated foreign earnings and cash related to the Tax Cuts and Jobs Act enacted that quarter.

GAAP net income for quarter 1 of 2018 was a loss of \$9.1 million compared to income of \$6.7 million for the first quarter of 2017 and a loss of \$11.1 million last quarter. Non-GAAP net income for the first quarter 2018 was a loss of \$14.2 million compared to earnings of \$8.9 million in quarter 1 2017 and \$2.5 million last quarter. Earnings per share on a GAAP basis, assuming dilution, was a loss of \$0.19 compared to income of \$0.14 for the first quarter of 2017 and a loss of \$0.23 per share for quarter 4 2017.

Non-GAAP earnings per share for the first quarter this year were a loss of \$0.29 compared to earnings of \$0.18 per share for quarter 1 of last year and \$0.05 per share for quarter 4 2017. Non-GAAP earnings per share, excluding the effects of stock compensation expense, amortization of acquired intangibles, restructuring expenses, the effects of the Tax Cut Act charges in quarter 4 2017 and the bargain purchase gain related to the acquisition in the quarter just ended. We've provided reconciliation between diluted GAAP earnings per share and diluted non-GAAP earnings per share in our operating results disclosure.

Now turning to the balance sheet. Unrestricted cash and marketable securities, net of debt, totaled \$208.2 million at quarter-end, after paying \$4.4 million in dividends and repurchasing 628,000 shares of common stock for \$10.2 million during the quarter. For the quarter, we produced \$46.2 million of cash from operations. Net trade accounts receivables were \$80.9 million at quarter-end, resulting in a DSO of 60 days compared to 45 days at the end of the first quarter of 2017 and 105 days at the end of quarter 4 2017. The decrease in our current quarter DSO versus last quarter as well as the increase in our cash flow from operations is primarily related to customer-specific payment terms and the timing of shipments within the quarter. The increase in DSO versus the same period last year is a result of the higher mix of international business in the current quarter. Inventories were \$120 million at the end of quarter 1, down from \$122.5 million last quarter.

Looking ahead to 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 the international markets we sell into may cause material differences between our expectations and actual results. However, taking into account the previously disclosed merger-related review and slowdown in spending at a domestic Tier 1 customer, our current expectations are that second quarter 2018 revenue will be in the range of \$125 million to \$130 million.

Also taking into account the potential impact of currency exchange rates and anticipated mix, we expect that our second quarter gross margins on a GAAP basis will be in the high 30% range due to the continued higher mix of international business. We expect that GAAP operating expenses for quarter 2 2018 to be approximately \$63 million. We expect other income to be in the range of \$2 million. And finally, we expect volatility in the quarterly tax rate for the rest of the year due to the anticipated mix of U.S. versus international income and the impact of the new tax law is having on those earnings.

While we had a tax benefit in the quarter just ended, we expect that the consolidated tax rate for the second quarter to be an expense of approximately 40%. We believe the significant factors impacting revenue and earnings realized in 2018 will be the following. The macro spending environment for the carriers and enterprises, currency exchange rate movements, the variability of mix and revenue associated with project rollouts, professional services activity levels, both domestic and international; the timing of revenue related to the Connect America Fund projects; the adoption rate of our Broadband Access platforms; and inventory fluctuations in our distribution channels.

I would again encourage our listeners to visit ADTRAN's Investor Relations website by going to www.adtran.com and following the Investor Relations link to take advantage of user-friendly resources such as interactive financials and to provide additional insight into our performance.



APRIL 18, 2018 / 2:30PM, ADTN - Q1 2018 ADTRAN Inc Earnings Call

With that, I'll now turn the call back over to Tom.

Thomas R. Stanton - ADTRAN, Inc. - Chairman & CEO

Thanks very much, Roger. Lynn, we're ready to open up for any questions people might have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll go ahead and take our first question from Doug Clark with Goldman Sachs.

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

I think my first one and the big one is, can you give us an update on what visibility you're seeing from your large U.S. customer that's gone on merger-related review? And also, when you've highlighted this at the end of 2017 and early -- the beginning of this year, you talked about a 90-day review process, which should have wrapped this up in the first quarter. So has this taken longer than expected? And again, what visibility you're seeing?

Thomas R. Stanton - ADTRAN, Inc. - Chairman & CEO

Yes, sure. So yes, it has taken longer than expected. So we continue to have conversations. There is -- needless to say, it was a slow rollout for this year, not only on major projects, but on just in general with that particular customer. So our outlook right now in Q2 really doesn't show any material change in that customer because I'm not sure that I can actually put a concrete time frame around any change in behavior. My general sense is that they're kind of formulating strategies around particular markets. And at some point in time, we'll see a change in that behavior. But at this point in time, we're kind of waiting and seeing and helping them with formulating different architectures and different plans and what the outcome would be in particular markets. So I would just say it's still going through a review.

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

Okay, that's helpful. And then, I mean, in terms of how large they are at this point, clearly, they may not be 0. How close to that are they? It sounds like you're still doing business with them outside of [maybe the major projects]?

Thomas R. Stanton - ADTRAN, Inc. - Chairman & CEO

Yes, so the way we think about this customer is when we have existing -- we have a very large footprint in this customer, so there's always existing business associated with card ads, subscriber ads and just -- and upgrades within that footprint. The second piece, of course, is the vectoring piece, which is the one that has been, by far, hurt the most in this review. And our -- so to add a little more color, our anticipation is that, over time, that there will be some vectoring, some super-vectoring, some G.fast and some GPON, and they'll be used in different parts of the network. But an overall inclusive plan is just not in existence in our mind at this point. And then the third piece of business is the CAF business, which we do. I mean, we have programs in place with them. They also got started slow this year. We see them picking up maybe a little in the second quarter. But the way that they're scheduling, we do have better visibility of those because those typically involve our services group. Those will actually meaningfully pick up in the second half, meaningfully for CAF. But here, again, in relation to the vectoring program, they're materially smaller.



APRIL 18, 2018 / 2:30PM, ADTN - Q1 2018 ADTRAN Inc Earnings Call

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

All right, I appreciate that detail. And then, my final other question was if we got to assume that, that customer is flat in the second quarter, we're not -- your guidance implies essentially no or very little seasonal growth or would it be kind of below seasonal?

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

I have that number right now. Yes, what we're seeing -- it's really more of what we experienced than what our conversations are. But what we've experienced so far, we're effectively showing them flat in the second quarter. And then, we do see the CAF pickup that's going to happen in the second half. And that's pretty deterministic. So a much better first half than second half. Having said that, we're not expecting any second half GPON or vectoring pickup until we actually see it.

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

Okay. The direction that I was going on the question was, the second quarter guidance excluding them doesn't seem to kind of match what was typically second quarter seasonal growth. I'm wondering if that's -- are you seeing less growth out of other pieces of the business? Or is it just the lack of the CenturyLink piece that's kind of mitigating that?

Roger D. Shannon - *ADTRAN, Inc. - CFO, Senior VP of Finance, Corporate Secretary & Treasurer*

Yes. In general -- so in general, CAF is a little late this year with the Tier 2s as well. So you're seeing that more back-end loaded in the second half -- excuse me, in the second quarter. But you are seeing a pickup there. There's going to be a pickup there. The majority of what you're -- of the impact is going to be because the largest customer in that space is just quiet right now.

Operator

Our next question comes from Rich Valera with Needham & Company.

Richard Frank Valera - *Needham & Company, LLC, Research Division - Senior Analyst*

So looking at the Q1 domestic revenue, it was down, I guess, 48% year-over-year, something about \$57 million in absolute numbers. Can you talk about how much of that was the M&A review with your big customer? How much of that is the rest of the business? I guess, just trying to get a sense of what the business is doing outside of this one big customer in the quarter in North America?

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

Yes, I don't have the number right in front of me. But my guess is going to be -- it's 90 -- it's high 90s percentage, that one customer, if not more. So that also impacted our services business as well. So in the U.S. -- last year, the U.S. Tier 2 market wasn't nearly as strong as it was in the year prior to that. So my -- the kind of high-level view is it's kind of -- that, that market is kind of flattish, maybe slightly down, but flattish first half and then we expect to pick up in the second half based off the programs that we're seeing today. And yes, I think that pretty much says it.

Richard Frank Valera - *Needham & Company, LLC, Research Division - Senior Analyst*

There's a number of programs, some of which you alluded to, that were expected to contribute kind of incrementally this year, NBN being one of them. AT&T, you mentioned, which sounds like it should be contributing incrementally, both in 1Q and 2Q. But frankly, they don't seem to be moving the needle given the guidance for 1Q -- the results for 1Q and guidance for 2Q. Can you give any sense of when these programs are expected to sort of contribute materially and kind of move the needle and perhaps make up for some of the softness with the one big customer?



APRIL 18, 2018 / 2:30PM, ADTN - Q1 2018 ADTRAN Inc Earnings Call

Thomas R. Stanton - ADTRAN, Inc. - Chairman & CEO

Sure. So the most deterministic thing, of course, is NBN because well, I'm going to -- let me not say that. The most deterministic thing that we have, of course, is going on in Australia. Because in that area, we have purchase orders in place. And it's a matter of us getting to the final approval process and actually beginning to ship those purchase orders. Barring any unseen today issues with the product, which we don't expect any, we did have some issues at the tail end of last year, which had us go back through some lab work at this point in time. We expect that to exit right around the end of the second quarter or early third quarter. And at that point, we have the green light to begin shipments there. So that's fairly deterministic. We know the size of the purchase orders that we have in place, and we have additional purchase orders that we expect to be coming in after that. So -- and that will happen in the -- we expect today for that to begin shipping in the third quarter, and we're fairly confident about that at this point. The G.fast opportunity here in the U.S., yes, it is starting to ship. It is still only shipping out of region. In region, of course, is a bigger market because the sales force that, that company has in place in region and because they have targeted specific builds. We're not completely out of the in-region field trial yet, but that should be wrapped up here in the next 30 to 45 days. So we would expect that here, again, to start picking up. You may see a little bit this quarter, but really starting to pick up in the second half.

Richard Frank Valera - Needham & Company, LLC, Research Division - Senior Analyst

And then on gross margin obviously taking a big near-term hit on, I guess, mix of international versus North America, but also because of the, I guess, the mix within the DT business. I mean, could you talk about if you think there's anything structural in that business? Or once you're done with this initial sort of greenfield footprint gain phase that those margins could sort of revert back to historical? Or do we -- again, do we think there's something, longer term, structural with those margins?

Thomas R. Stanton - ADTRAN, Inc. - Chairman & CEO

Those will absolutely positively revert back to historical. So we shipped a significant number of starter kits in Q1, which includes chassis and things that we've talked about previously on the call. Those ultimately are good things, because you're filling them up with line cards after you actually expand your footprint. But a lot of that happened in Q1. That will actually get better in Q2. You'll probably -- you'll see margin improvement in Q2 predominantly because of that mix shift in the product for that customer. We expect another very strong quarter with that customer. They were very big in Q1 as well. So you'll see that revert up. And then in the second half, you'll see a stronger U.S. mix. So you'll see margins again increase in the second half versus the total first half.

Richard Frank Valera - Needham & Company, LLC, Research Division - Senior Analyst

And one last final one for me. I know you don't like to comment beyond forward guidance, but given the kind of extraordinary circumstances here and now with your revenue levels. I mean, is there anything you'd be willing to say about third quarter revenue levels relative to second quarter? I mean, I would assume we would expect better-than-historical seasonality given sort of what a low level we're at and expect to be at in Q2. But is there any color you'd be willing to provide on that?

Thomas R. Stanton - ADTRAN, Inc. - Chairman & CEO

Yes, I hear you. I'm not going to try to reach too far out, but let me just kind of relay what we know, right? So in the U.S., we're going to see a pickup in cap spending. We know that, right? Those projects are in-house and have been identified. And it's a matter of getting the engineering and installation work done on that. So you'll see that pick up and you'll see that pick up in Tier 1s as well as Tier 2s. We will see a pickup versus -- definitely versus Q1 and more than likely in Q2 and our business with G.fast, and that will happen in the second half. You will see us, barring the unforeseen things that I've talked about with the material pickup in our Australian business, and -- which will be meaningful for us. You will also see a material pickup in the MSO business in the second half of this year. Some of that has to do with the recent acquisition that we have, and some of that has to do with just the ongoing work that we've been doing in that space. So we would expect, at this point in time, to see a more than seasonal increase



APRIL 18, 2018 / 2:30PM, ADTN - Q1 2018 ADTRAN Inc Earnings Call

in Q3 and then sustaining in Q4. And then as we look forward into next year, based off the programs I just said along with some other programs that I mentioned in my conversation, we see them -- right now, things look good. So that's as far as I probably want to go into that.

Operator

Our next question comes from George Notter with Jefferies.

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

I guess, I just want to make sure I understand where you were really surprised in the quarter. I think going in, you did expect to have certainly a stronger mix of international. Did you expect to have a bigger mix of chassis versus line cards and capacity ads on the international business? I guess, I'm trying to really handicap the price in gross margins relative to what you were guiding.

Thomas R. Stanton - ADTRAN, Inc. - Chairman & CEO

Yes, we did expect to have a higher mix. The -- but to get right down to the situation that changed on the gross margin piece, that customer, we ended up shipping. So we have a fairly -- I've mentioned for our customer forecast fairly well and then places orders and it's a relatively straightforward process compared to most carriers. What had -- that particular issue had more to do with availability of our products. So we have a, we'll say, a bucket of things that we can ship. And where we ended up having availability on the chassis line card starter kit, more so than we had on line cards, which actually negatively affected the mix. And that was a material change. So those line cards will start shipping in Q2. We did not know that coming into the quarter that we're going to have that issue.

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

Got it. Okay. And then, if I just look at the breakout of services versus product. It seems to me like the real outliers in the services business, obviously, had a big step down sequentially. I guess, I would have imagined that, that change would have helped gross margins to some degree. And the product revenue looked like it was pretty consistent with historical seasonality. Obviously, you had a really low point in the December quarter. But again, is it a surprise on services? And how did that play in the gross margins?

Thomas R. Stanton - ADTRAN, Inc. - Chairman & CEO

Services -- so let me give you a little more granularity there to help you kind of understand the quarter. So our European business was up a little higher than we expected with bad mix. That bad mix is not necessarily due to the customer's fault, it's just with what we ship them. If you recall, we initially -- which colors this a little more and tells you how much stronger the international business was than we initially expected, we had initially expected to ship some of our Australian customer this quarter. That has slid out. So that was a negative on gross margins as well. Services itself, services are typically historically less than product margins. But I will tell you the European mix thing that I was talking about made that kind of not so strong, not that big of an issue in Q1. So it was services -- historical services gross margins are probably -- are very much in line with what our gross margin (inaudible) Q1. So they were -- it was materially (inaudible) because of those starter kits. We also have initial courses that we saw a significant decline in our services business. And we are in the mix, which we've kind of alluded to in our conversations, too. We were right in the mix of trying to get our services overhead and cost back in line with the current rate of business. So that impacted the gross margins as well.

Operator

Our next question comes from Bill Dezelle with Tieton Capital.



APRIL 18, 2018 / 2:30PM, ADTN - Q1 2018 ADTRAN Inc Earnings Call

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

I believe in your opening remarks, you made reference to 9 additional international wins. If that's correct, would you please discuss those wins in aggregate and revenue size and the timing of when we might begin to see those?

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

Yes, sure. So my comments actually were in relation to U.S. customers. So those were larger Tier 3s and some Tier 2 business that we actually picked up here in the U.S. Internationally, we did win some additional business outside of the U.S. predominantly -- other than the ones that you already know about, predominantly in Europe. So we did pick up a couple of services businesses, a couple of awards for services business in Europe as well as we, in a separate Tier 2 carrier, we were able to displace an incumbent and we're doing -- we will begin a network rollout to replace that equipment sometime in the second quarter. So -- but that was -- the 9 comment was in relation to the U.S. business.

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

And Tom, those 9 in aggregate, are -- would they be considered material or not? And what's the timing of recognizing that revenue?

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

It will be in the second half. In aggregate, yes, but they're not of the same sizes. Think about that more like in aggregate as being a large Tier 2, not really a Tier 1 carrier.

Operator

Our next question comes from Michael Genovese with MKM Partners.

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

First question, I just want to understand the 2 10% customers. I assume one was a large European customer. The second, would that be Tier 1 with the review? Or was it another U.S. Tier 1? Was it a U.S. Tier 2? Was it other? Who was that second?

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

Yes, so it's 1 European, 1 U.S. So you're correct in your assumption. And the review is absolutely a Tier 1 carrier in the U.S. that started really in the fourth quarter.

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

Right.

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

Did that answer your question?



APRIL 18, 2018 / 2:30PM, ADTN - Q1 2018 ADTRAN Inc Earnings Call

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

Well, I guess, I just -- was the second one a Tier 1 or a Tier 2?

Thomas R. Stanton - ADTRAN, Inc. - Chairman & CEO

Oh, the second 10%?

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

Yes.

Thomas R. Stanton - ADTRAN, Inc. - Chairman & CEO

I'm going to have to get to my disclosure person here. Do we -- what do we typically say? I think we probably just break it down as -- we typically break it down as just U.S. and domestic.

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

Okay, fair enough. I just have one more question. And just thinking about the next couple of years in gross margins. For the U.S. business and broadband, so your Broadband Access portfolio. Is there a difference in gross margin profile for copper telecom products, fiber telecom products and cable products? Or do they all roughly run at about the same gross margin potential?

Thomas R. Stanton - ADTRAN, Inc. - Chairman & CEO

For the infrastructure piece itself, they run roughly the same gross margin potential. When you get into the CPE associated with fiber, then that tends to be lower gross margin. And just to maybe add some more color so that people can understand the gross margin, the gross margin impact in Q1, if I look at the product shipments associated in the U.S., there was not a gross margin issue associated with those shipments in the U.S. So there wasn't a material change in the pricing environment or anything like that in the U.S. We literally had a mix issue and then we had a services margin issue. We had a mix issue in Europe and then we had a services margin issue. But -- so we haven't seen an environment change. We haven't seen a vendor change from our -- from vendors supplying to us. It's fairly constant. It's been consistent now for a few years, and it's -- it remains consistent. Our issue right now is the -- we had a material decrease in our business. We have to readjust to that decrease, and at the same time, keep in places the things that are going to drive the second half and what we expect to be a very strong 2019.

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

Right. And then just finally, as a follow-up on that. So the CPE, fiber CPE, I assume that when you're talking about telco or cable MSO, that's going to be similar -- the similar gross margin and similar sort of mix dynamics between CPE and Network Equipment? My question is just are the margins of the cable and the margins of the telco roughly the same for fiber?

Thomas R. Stanton - ADTRAN, Inc. - Chairman & CEO

Well, one is I don't want to get in trouble with my customer base. I'm talking about margins too granularly in saying that one pays more than the other. But in reality, they are similar. There are things that will play into a particular gross margin for product, and it has more to do with the commodity nature versus the more custom nature of particular customer requirements. Things that are more customer -- customized tend to have a higher gross margin profile. But in general, the theme of infrastructure versus termination carries through regardless of the market or geography.

APRIL 18, 2018 / 2:30PM, ADTN - Q1 2018 ADTRAN Inc Earnings Call

Operator

Our next question comes from Adam Thalhimer with Thompson Davis.

Adam Robert Thalhimer - *Thompson, Davis & Company, Inc., Research Division - Director of Research*

The Tier 1 customer with the review, you said vectoring was, by far, hurt the most. I'm curious, how did GPON/fiber hold up?

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

I didn't -- I don't -- I would say it got hurt as well. So the reason vectoring hurt the most is because that, by far, the biggest. But in our -- in my opinion, anything that isn't kind of business as usual, business as usual being ads and leads from various space or CAF, which here again was impacted by a slow start but it will happen, anything that's not one of those 2 is under pressure right now (inaudible)

Adam Robert Thalhimer - *Thompson, Davis & Company, Inc., Research Division - Director of Research*

Got it. And then just lastly, a quick question on the NG-PON2. You said your engagement on that project is at a peak level. Can you give a little more color on that?

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

Sure. So we have some very tight timelines that we're working with the customer on. And from an engineering perspective, we're -- we just have to deliver. So we think that the prospect looks very good. Of course, it's more back-end loaded. We expect a substantially strong 2019. Not just stronger, but strong in -- on its own right. And we expect to see some material movements on the next couple of quarters that are very important for the company. So our engagement with that customer in that we're actually talking about world equipment going. We have product in the lab today and it's a matter of us getting through that process as quickly as possible.

Operator

Our next question comes from Paul Silverstein with Cowen.

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

A couple of questions, if I may. First off, Tom, going back to the question on project size. I recognize you have a whole -- there's a whole variety of projects in scope and size. But as a general proposition, when you get a Tier 2 customer, what's the points that you only get Tier 1? When you get a Tier 2 customer, where do these projects typically run in total size on an annual basis? And how does that compare to a typical Tier 1 project in total size on an annual basis? Again, I recognize there's a whole range of different projects. But can you give a general sizing? Then I've got a follow-up question.

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

Yes. But it's a -- let me just relay to you the information and then you'll understand why it's difficult. So the custom -- Tier 2 business tends to come project-related. So there are times where Tier 2 customers are incredibly meaningful. And there's times where any single Tier 2 customer, as you know, we've had Tier 2s that have been 10% customers for us periodically. So you really need to align the particular customer with projects. And the whole key to this for us has been they also tend to find market share or market agreements with you, which allow you to participate heavily



APRIL 18, 2018 / 2:30PM, ADTN - Q1 2018 ADTRAN Inc Earnings Call

when those projects come align or come alive. The Tier 2 space today is not as strong as it was 2 years ago by any stretch. And in fact, it's probably gotten a little weaker than last year. There are programs that are announced in the Tier 2 space that are expected to start delivering really in Q2 and then they pick up some in the second half. So in the Tier 2 space, our line of sight shows us we're going to have a stronger second half -- on a percentage basis, materially stronger second half than the first half. But I don't expect that to bounce back to the level that we saw when they were doing 2 years ago, and there were some specific highlighted projects that were very strong. But we do expect to see a pickup in the second half.

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

Got it. And another question for Roger. I recognize that there's some near-term issues. But longer term, can you give us an update on what -- where you think margins can bounce back to? What if the business gets back on track and everything's cranking? Where can the company get to in terms of peak margins?

Roger D. Shannon - *ADTRAN, Inc. - CFO, Senior VP of Finance, Corporate Secretary & Treasurer*

Yes. So like Tom said a little earlier, we expect margins to bounce back to kind of historical levels. We talked through the factors that affected Q1. It's going to carry forward into Q2. But we'll see an improvement in the domestic proportion, the domestic mix. So we expect that will -- we'll kind of have a reversion back to those historical levels.

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

Can I -- guys, can I push you because once upon a time, you all -- if I remember, you actually hit 60% gross margin (inaudible) that was a (inaudible) impact.

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

Yes, yes, but that's also when we had no business outside of the U.S. That was immaterial. So the -- just to remind everybody, gross margins in -- outside of the U.S. are typically 10% lower than what we see in the -- inside the U.S. In aggregate, with normal mix, this was historically high. We have never seen near-50% international mix before, at least not that I can recall. And I think we actually looked back. So this is not a normal seasonal period for us or a normal time for us. But our blended gross margins have been in the 46-ish range. And being that nothing has fundamentally changed, that's where we would expect them to get back to.

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

Right. One last question, if I may. You all are a season mature company. And historically, I thought a very well-run company. So that's -- Tom, how -- from a manufacturing standpoint, how is it you can get surprised in terms your inability to shift against your requisite demand? When you say you had starter kits ready but not the line card, how long does it take you to manufacture a line card? How much visibility do you have? How does something like that come to transpire?

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

You have a connector that comes from the vendor and it doesn't work.

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

Okay. That's basically--



APRIL 18, 2018 / 2:30PM, ADTN - Q1 2018 ADTRAN Inc Earnings Call

Thomas R. Stanton - ADTRAN, Inc. - Chairman & CEO

That's what happened. And that does happen periodically, just not that often.

Operator

Thank you.

Thomas R. Stanton - ADTRAN, Inc. - Chairman & CEO

I think that's the last question on our call that we have. So I appreciate everybody hanging with us this quarter. We hope to bring you better news in the upcoming quarters, and I look forward to talking to you again. Thanks very much, everyone.

Operator

This does conclude today's program. You may disconnect your line at any time, and have a wonderful day.

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