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DZSI - Q2 2018 DASAN Zhone Solutions Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the DASAN Zhone Solutions, Inc. Second Quarter 2018 Earnings Conference Call. (Operator Instructions) And as a reminder, this conference is being recorded.

I would now like to hand the call over to Ms. Pei Hung, Vice President of Investor Relations. Ma'am, you may begin.

Pei-Hua Hung - *DASAN Zhone Solutions, Inc. - VP of Finance & IR*

Thank you, operator, and good afternoon, everyone, and thank you for joining us on our Q2 2018 earnings call. Joining me on the call today are the Chief Executive Officer of DASAN Zhone Solutions, Yung Kim; as well as Chief Financial Officer, Mikhail Golomb.

This afternoon, DASAN Zhone Solutions issued a press release announcing the results for its second quarter 2018. If you would like a copy of the press release, you can access it online in the Investor Relations section of the company's website, www.dasanzhone.com.

During the course of this call, we will refer to forward-looking statements regarding our future financial and operating performance and our growth strategy. Listeners are cautioned that actual results could differ materially from those expressed in or contemplated by the forward-looking statements. Factors that could cause actual results to differ are detailed in today's earnings press release and in our annual and quarterly reports filed with the SEC. The company undertakes no obligation to update or revise any forward-looking statements.

Please also note that certain financial measures we use on this call are expressed on a non-GAAP basis. We have provided reconciliations of these non-GAAP financial measures to GAAP financial measures in our earnings press release.

Finally, note that our Q2 2018 results and forward-looking guidance are provided under ASC 606, which we adopted on January 1, 2018, on a modified retrospective basis.

With those comments in mind, I would now like to introduce Yung Kim, CEO of DASAN Zhone Solutions. Yung?

Il Yung Kim - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Thank you, Pei. Good afternoon, everyone. I'd like to begin by discussing our second quarter results. As I look at our performance in Q2 2018 and through the first half of 2018, I'm pleased by our progress on many fronts.

On the revenue side, we continue to seize the global fiber-to-the-home opportunity in our core broadband access business as we grew our total revenue in Q2 to $76.3 million, which represents a 27.2% year-over-year growth and reflects the higher end of our guidance.

For the first half of 2018, our revenue totaled $135.8 million, which was up 21.2% year-over-year. Our Q2 growth was driven by a sizable contract with the Indian state government of Andhra Pradesh to build out their next-generation high-speed optical fiber network infrastructure across 13 districts within the state.

While the Indian market is an exciting one for us given the significant greenfield opportunities across all 29 states, I would characterize the India opportunity as additive to our existing core business that is already strong, globally diverse and one that benefits from broad-based opportunities across our 1,000-plus customers.

To that end, we continue to see the acceleration of fiber-based GPON as one of the fastest-growing broadband access technologies across global markets as the confluence of factors has made the supply-side and demand-side economics work very well in our favor.

On the supply side, the fiber economics compare extremely favorably versus xDSL speed upgrade costs, particularly in cases where there are additional incurred costs in moving street cabinets closer to homes. The fiber OpEx savings have been demonstratively superior than copper OpEx. But now the CapEx savings are starting to make a substantial difference given the unlimited bandwidth capacity from fiber deployments. I believe that this CapEx pricing phenomenon is driven in large part by large-scale GPON deployments in global markets, especially in China, and the increasing economic development advantages of a connected fiber access network.

On the demand side, over-the-top providers, such as Netflix, Amazon, YouTube and others, are driving bandwidth consumption like never before as they are increasingly recording and delivering ultrahigh-definition video contents in 4K and 8K, which requires 16x more bandwidth for 4K and 64x more bandwidth for 8K than high-definition 1K video. As important, ultrahigh-definition displays are more ubiquitous than ever before, further driving higher bandwidth requirements. This is where the bandwidth limitations of a copper access are quickly becoming apparent, resulting in an increasing number of carriers bypassing copper upgrades in favor of new fiber optic deployments.

The confluence of these factors makes me very confident that we are in the midst of a robust $10 billion-plus multiyear investment cycle for fiber-to-the-home, which I believe is the most future-proof technology option available. I believe we are uniquely able to capitalize on the market's tailwind given our scale, our diverse geographic footprint and our comprehensive and innovative product portfolio serving Tier 1 carriers in Asia and the Middle East as well as Tier 2 and Tier 3 carriers and alternative providers in North America, Latin America and Europe.

Besides fiber-to-the-home momentum, we also see other growth green shoots in our business. As an example, we are working with the Tier 1 carriers, primarily in Asia, to help them build out their 5G infrastructure, including providing our ultralow-latency switches. Although not in our public forecasts, this can translate into what I would consider a tens of millions type of revenue opportunity for a single Tier 1 carrier. I believe this is a tangible opportunity that can be cross-sold to a broader set of our customers in other regions.

We are also working with the Tier 1 carriers, primarily in Asia and the Middle East, on NGPON2-related technology and product testing. But I believe this is a market that will take time to materialize given the high costs of the optical transceivers today.

Finally, as we previously mentioned, we are on track for the launch of our FiberLAN 2.0 offering into the enterprise market in the latter half of this year that would be plug-and-play and would be purpose-built to meet enterprise requirements.

I'm very excited by these growth levers, which are currently not in our public guidance, that will be additive to our core growing broadband access business.

Now turning back to our financial results. On the margin front, our gross margin was 30.4% for the June quarter, which met the mid-range of guidance and reflects the impact of the geographic mix in the quarter, which was, in large part, driven by the large contract in India.

Equally important, we continue to deliver profitability across our operating income, net income and adjusted EBITDA. We generated GAAP earnings per diluted share of $0.08 in the quarter. Due to a strong focus on cost containment initiatives, we successfully beat our adjusted operating expenses in the quarter, which were $19.8 million against the prior guidance range of $20.7 million to $21.5 million. As a result, we generated $3.2 million of adjusted EBITDA, which greatly exceeded the guidance range of $1 million to $2.5 million.

With this overview, let me turn the call to Mikhail who will discuss our quarterly financial results in more detail. Mikhail?

Mikhail Golomb - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

Thank you, Yung, and good afternoon. Today, I will speak about our second quarter 2018 results and discuss what we are seeing for the third quarter 2018 as well as provide a revised outlook for the full year 2018 revenue.

We last provided you with the guidance regarding the Q2 2018 quarter on May 10. In that guidance, we called for Q2 '18 revenue to be between $72 million and $78 million; a GAAP gross margin of between 30% and 31%; adjusted operating expenses, which exclude depreciation and amortization, stock-based compensation expenses, to be between $20.7 million and $21.5 million; with an implied adjusted EBITDA range between $1 million and $2.5 million.

Relative to the guidance, I'm happy to report that our actual revenue for the second quarter came in at the higher end of the guidance at $76.3 million, which is up 27.2% year-over-year compared to $59.9 million reported in Q2 2017.

Overall, the revenue strength in Q2 was broad-based with year-over-year growth across almost all geographies, with particular strength in our Asia Pacific markets. Overall, North American market grew 12% year-over-year to approximately $50 million of revenue, and international markets grew 32% year-over-year to approximately $61 million of revenue.

In our Q2, we generated approximately 80% of our revenue outside of North America. Across international markets, Asia Pac contributed 58% in Q2. We are also seeing strong customer traction in our Europe and Middle East markets, which collectively accounted for approximately 12% of our Q2 '18 revenue.

From a customer perspective, we had a sizable contract from Andhra Pradesh State Fibernet Limited or APSFL, which is the wholly owned subsidiary of the Indian state of Andhra Pradesh that is deploying a statewide next-generation high-speed optical fiber network infrastructure. As such, APSFL became a sizable customer in second quarter and contributed approximately 22% of the quarter revenue. As Yung discussed, there are tangible opportunities to grow the APSFL relationship, but we would characterize the Indian opportunity to be additive and not captured in our public revenue guidance. In the coming quarters, we expect to see continued customer and geographic diversification, as we have seen in prior quarters, without the onetime impact of the large India contract.

Now let me turn to the gross margin. Gross margin of 30.4% came in line with our original gross margin guidance of 30% and 31%, primarily driven by the APSFL contract in India, which, while profitable, was below our typical customer margin profile. The good news in that is we do see gross margins normalize with APSFL as we continue to broaden our product mix to include higher-margin (inaudible) devices. I would not be surprised to see additive revenue from APSFL and other neighboring states in India at higher margins due to more favorable products, product mix as well as leveling out initial ramp-up costs.

Let me spend some time addressing our operating expenses now where I believe we have made meaningful strides since last quarter due to continued cost containment initiatives. In Q2, our total GAAP operating expenses were $20.6 million, an increase of only $0.3 million compared to $20.2 million for the second quarter in 2017 even with our revenue growing of more than $16 million in a year-over-year basis.

On a quarter-over-quarter basis, our total GAAP operating expenses in Q2 reflect the reduction of approximately $0.9 million from $21.5 million in Q1 of '18. Our non-GAAP adjusted operating expenses for the quarter were $19.8 million, which came in significantly below the guidance of $20.7 million to $21.5 million. The difference between GAAP versus non-GAAP operating expenses in Q2 was due to depreciation and amortization expenses and stock-based compensation expenses.

On a non-GAAP basis, our adjusted EBITDA for the second quarter 2018 was $3.2 million, reflecting the margin of 4.2%. Our adjusted EBITDA exceeded our previously provided guidance range of between $1 million and $2.5 million, benefiting from strong revenue growth and decrease in operating expenses from prior quarters.

In the second quarter 2018, we continue to be profitable in GAAP basis, posting net income attributed to DASAN Zhone Solutions of $1.4 million or $0.08 per diluted share as compared to net loss of approximately $0.8 million or loss of $0.05 per diluted share for second quarter of 2017.

Now turning to another topic at hand. I would like to preemptively address potential impacts if tariffs materialize between the United States and China. Put simply, we are able to leverage flexible production out of our own in-house manufacturing facility in Florida and from our Korean contract manufacturers. Also, our revenue basis is very geographically diverse, as already discussed. Depending on the quarter, we generate approximately 70% to 80% of our revenue outside of the United States. Given this, we are relatively shielded from potential tariff risks.

Now I would like to turn to a discussion to our revenue outlook for the third quarter 2018 and provide revised full year 2018 revenue guidance. For the third quarter 2018, we expect revenue to be in the range of $70 million to $74 million or approximately 5% to 11% year-over-year increase from the prior year quarter of $66 million. This reflects continued solid growth in run rate business without the benefits of large onetime opportunities.

We expect our Q3 2018 GAAP gross margins to be approximately 32%, which does reflect impact of increased revenue from our Asia Pacific region. We expect Q3 2018 non-GAAP adjusted operating expenses to be approximately $20 million, which is modestly higher than Q2 levels to reflect ongoing initiatives to build out our R&D capabilities in regions like Vietnam.

For the full year 2018, we are revising revenue to be in the range of approximately $280 million to $285 million of approximate 13% to 15% year-over-year growth as compared to prior guidance provided on May 30 in the range of $272 million to $280 million or approximate 10% to 13% year-over-year growth.

While we believe there is continued and significant growth opportunities in a market like India, which is further bolstered by our green shoot growth opportunities, including our enterprise-focused FiberLAN 2.0 product launch, we did not consider it in our full year 2018 top line outlook.

At this point, let me turn the call back to Yung. Thank you.

Il Yung Kim - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Thank you, Mikhail. To wrap up, we are proud of our progress we made in the first half of 2018 where we grew our revenue close to 21.2% year-over-year and grew our adjusted EBITDA to $4.7 million from an adjusted EBITDA loss of $0.5 million in the first half of 2017. We are excited for our long-term revenue growth and profitability prospects and continue to believe that the market opportunity is ours to seize.

Operator, we are now ready to open up for any questions that our listeners might have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Christian Schwab of Craig-Hallum Capital.

Christian David Schwab - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

As you guys look to FiberLAN and the initiatives, can you kind of just give us an update on kind of a multiyear outlook in opportunity from that yet?

Il Yung Kim - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

I think it is too early for me to give you guidance because we barely finished the development. And we are heading into distributed trial, and we are gauging the potentials with the global distributors around the world. So maybe early next year, I may be able to give you some heads-up. But until then, I think it is something that I have something dear to my heart, that what's happening in the sort of fiber-to-the-home in the broadband access market will inevitably play out in the enterprise market. That's delivering gigabit to the desktop, and the GPON technology is the best technology to tackle that. And that is my belief, and that's why I'm staying in this company to run that. But sorry that I can't give you a number today.

Christian David Schwab - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

No problem. Given the strong revenue growth year-over-year in '17 to '18, different opportunities for growth, whether it be FiberLAN or opportunities in India, et cetera, as you look at the opportunities in front of you over the next 3 to 5 years, what type of growth do you think you guys are capable of driving on the top line?

Il Yung Kim - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

I think as I said in my sort of earnings call, that it's really we have this in Netflix, YouTube and Amazon. Even now, Walmart is coming to the streaming business. And also, the low cost of displays, it's literally there is no other sensible solution long term other than the fiber-to-the-home. And therefore, as you -- we see some market reports of 15-plus percent compound growth for next 10 years. And I think this is ours to seize that rather than tailing off from that. So I see continuously that I'd like to grow this business, but I don't want to be bullish too much because there are always competitors and people try to have better solutions, better products. So I have to be cautious and plot my path. And Mikhail?

Mikhail Golomb - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

Plus, the fact that we are geographically diversified also gives us an appetite for more than others.

Operator

(Operator Instructions) The next question is from the line of Dave Kang of B. Riley FBR.

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Just wanted to focus more on the -- this Indian market. So first of all, just wanted to get your third quarter outlook assumption of this particular Indian customer.

Il Yung Kim - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

I think we may have an opportunity, which we are working on, is very much the central office equipment, which we call it OLT because they built OLT many years ago from Portugal Telecom, which were a system integrated by Cisco. Now that we are -- we have provided a larger number of ONTs, I'm sure that the opportunities are there for us to provide OLT. But because it's not ONT, the numbers will be significantly smaller than the Q2, but it will give us opportunity to go to -- to grow again in the future. And we are also working with the neighboring states while trying to -- try similar kind of rollout. A whole of India is trying to roll out fiber-to-the-home, and BSNL, which is a government agency, is awash with money to dish out.

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Right. And this year, if I heard you correctly, I believe you said this customer was something like 20% of revenues, which is, well, like mid-teens, like $15 million, $16 million last quarter. And then your debt is dropping off, and yet your sales will be down just modestly. So what's making that up from second to third quarter?

Il Yung Kim - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

We generally have Asian strength coming and South America strength coming. We have opportunities building up again in Middle East. So that, as Mikhail said, we have a very robust sort of diverse customers, so we are not affected by a single optic customer.

Mikhail Golomb - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

Yes, and I can actually add to that. So we -- if you take this customer out in onetime bump or this 1-quarter bump, we -- all of our other 9 customers, they don't even come close, and actually, they go between 9% and 7%, 6% or so. And if you take 6 months, also, we don't have any single customer over 7%. Only this Indian customer comes a little bit over 10% at a group level. So that's actually not bad. And they're -- all of these customers are geographically spread across the whole world, which is exciting.

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Got it. Is your -- I assume your -- well, I guess what's your lead, typical lead time? Is it, like, maybe a few weeks? Or is it a few months? Can you characterize what your typical lead time is?

Il Yung Kim - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

I mean, lead time from the customer engagement to the orders? Or...

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

No, actually orders to ship.

Il Yung Kim - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Orders to ship, it's very much between about 6 weeks onwards. We don't build anything -- we don't build lots of things as the inventory and ship. Mostly, we stock small amounts, and the big orders are -- once order is taken, we give a delivery time sort of 2 months usually and 6 weeks. So we don't take any risk of building inventory and expecting customers and ship it. So that is one of our strengths and operational, I would say, excellence is -- our flexible manufacturing, which is different from our competitors, is we do not outsource completely to manufacturer. What we have is we have our own production engineers, and we go and borrow people and the floor space of a factory. We set it up the production line and then let them run their factory with our test equipment and all that. So because of that flexibility, we don't have to give them long-term orders, which normal outsourcing companies, for example, like Foxconn, they will ask your forecast of a year and orders of 3 to -- maybe 6 months advance orders. But we don't do that kind of thing, okay? They do.

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Actually, I was thinking more like, is your business more backlog or turns business? That's what I was after.

Il Yung Kim - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

We have a sizable backlog. So any fluctuation that comes in our production can be smoothed out by our backlog. So that's one thing that -- since I joined this company, we changed our compensation to our sales in such a way that the whole cycle of order taking and the delivery to the cash collection is incentivized by that process. Therefore, they have incentive to actually take orders early on so that we can smooth out production and the delivery. So we have some -- unusual orders goes up to a year, but usually, we get something like 3 months to 6 months, that kind of time.

Mikhail Golomb - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

David, actually, a couple -- David, to answer a couple other -- to relate, so in Q2, 18% of our revenue came from United States and 2% from Canada. So 20% from North America. And then we had 10% from Latin America, and then about half came from Asia Pac, just to give you a flavor. Year-to-date, we have 24% from North America, of which 22% from United States, again, to give you a flavor. And then about 50%, including that bump, right, from Asia Pac, just to give you a flavor. So you can see that it's not that big of a deal. We can be very diversified, yes?

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Yes. The reason I was asking is because I'm looking at your annual guidance, and it's like only $5 million window. Typically, I mean, the companies that I follow, they give much wider window, and that's just for the quarter. So just wondering just what kind of visibility you have for multi quarters out. Seems like you have a pretty good idea of how things are going to develop this year.

Il Yung Kim - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

I usually have a pretty good window up to about 2 quarters.

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

I see, okay.

Mikhail Golomb - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

When we guide, we meet our numbers.

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Got it. And just a couple more if I could. Now that ZTE is back, was there a lot of overlap between you and ZTE?

Il Yung Kim - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Not a lot at all because we've been invited where ZTE has been retreated. We are doing some work to help operators in some Asian countries, and we are also getting into some -- South America but not in Europe. So we don't -- we compete in Asia. We used to compete quite heavily in Asia. And because of that, we had a reputation. We heavily competed with Huawei and ZTE and Nokia. It was a very severe battleground.

Mikhail Golomb - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

And David, just to add to that point, even with -- you heard me just telling you about the breakdown of our revenue, right? Even with competing with all -- competing heavily against Huawei, ZTE, we were able to lower our DSOs below 80. When you compete with -- on that ground, they give sometimes a year payment terms, and we were able to, competing with -- on those grounds, lower our DSOs below -- to 79.

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Got it, got it.

Mikhail Golomb - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

Which we also replayed.

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Yes. And then I -- Mikhail, I think you talked about potential impact on your business from these U.S. tariffs. But can you just talk about how that will impact the overall industry and whether -- can you summarize whether it's a net positive or negative for you?

Mikhail Golomb - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

Okay. So yes, we believe it's -- well, we believe it's going to be probably positive for us, especially because of the revenue breakdown for our company. We are very global, very diversified. So we don't think there's going to be any impact for us. As we discussed, we have manufacturing location in Florida, and we're proud to produce products in the United States. We also have -- as Yung just discussed, we have a flexible manufacturing location in Korea. We also have production close to -- in India and also in Vietnam. And also, we have some work in China. So we're very diversified depending where -- we listen to our customer. We produce what customer wants. Now some of our colleagues in the market, they're very focused to cost effect, and they don't -- sometimes don't care about diversifying risk. So the market will show what happens.

Il Yung Kim - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Actually, the way I look at that is, for us, as I've mentioned earlier how manufacturing technique has -- we can actually shift manufacturing fairly quickly. However, I think the plus side is our -- we are shipping to North America. Our China dependency or -- to U.S. is very small.

Ku Kang - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Right. But then on some of your major domestic competitors, don't they have most of their products made in China? How quickly do you think they can shift out of China into other regions? And could that open up an opportunity for you to kind of get into the U.S. market?

Il Yung Kim - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

I -- it's really -- it's how well they do it if they have time to dwell on. And for me, I know how quickly I can move.

Mikhail Golomb - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

Dave, what's important is that we've -- the company has been competing all the time with big companies like Huawei, ZTE and been winning those projects and competing on a global scale and those margins where -- in bringing money to the bottom line to investors. That would be a good test right now for the other companies now that they have to compete on a global basis, too. Let's see what happens.

Operator

Thank you. And with that, that does conclude our call for today. Ladies and gentlemen, thank you for your participation. You may now disconnect. Everybody, have a great day.
