Transcription

ADVA Optical Networking SE

July 25, 2019

EV00092728

Thursday, July 25, 2019

00:00:02 Operator
Dear ladies and gentlemen. Welcome to the conference call of ADVA Optical Networking for the 2nd quarter 2019 IFRS financial results. This call is being recorded. After the presentation there will be an opportunity to ask questions. I now hand over to Mr. Stephan Rettenberger, ADVA Optical Networking's Senior Vice President Marketing and Investor Relations. Please go ahead, sir.

00:00:41 Stephan Rettenberger
Thank you for the introduction and welcome from my side. This earnings call is built on a presentation which is available for download in PDF format from our homepage under www.advaoptical.com in the About Us/Investors section. Should you not have the presentation in front of you, you may want to access it on the conference call's page in the financial results section of the investor section of the website. Before we lead you through the presentation, as always please be informed that this presentation contains forward looking statements with words such as believes and anticipates and expects to describe expected revenues and earnings, anticipated demand for optical networking solutions, internal estimates and the liquidity. These cycles are discussed in greater detail in the risk report section of our annual report 2018. Please also be reminded that we provide consolidated pro-forma financial results in this presentation solely as supplemental financial information to help the financial community make meaningful comparisons of our operating results from one financial period to another. This pro forma information is not prepared in accordance with IFRS and should not be considered as a substitute for historical information presented in accordance with IFRS. Pro forma operating income or losses calculated prior to non-cash charges related to the stock compensation programs and amortization and impairment of goodwill and acquisition-related intangible assets. Non-recurring expenses related to restructuring measures are not included. Unless stated otherwise, all numbers are presented in euro. We will target to limit this conference call to 60 minutes, as usual Brian will start and provide a business update and outlook and Uli will talk us through our Q2 2019 financials. And finally, we will have sufficient time for your questions, which we will be happy to answer. With that I hand over to Brian. Please go ahead with the business update.

00:02:58 Brian Protiva
Thank you Stephan. So as always we start with the business update and outlook on page no. 4. Q2 revenues reached EUR 133.2 million, up nicely by 7.6% year over year from 123.8 million in Q2 2018. This is within our guidance corridor, provided on April 18, 2019 of between EUR 130 and 140 million. Our Q2 2019 pro forma operating income was at EUR 4.3 million or 3.3% of revenue, and thus around the mid-point of our guidance of between 2 and 5% of revenue. Both revenues and profitability developed within our guidance, even though we had to push off revenue recognition of one large project. We achieved some great customer success in Q2, with an impressive win rate. Our order entry was strong, and we are going into Q3 with a significant backlog. While the demand for our solutions is very healthy, we see the strengthening US dollar, US China trade tensions with related costs and our product customer mix putting pressure on our margins. Most importantly, however, we are excited to report that many of our new wins come from our recent technology investments. Our win rates with new products are very high, allowing us to realize higher margins in our new market segments. Our achievements here further underscore our confidence in the market and our growth opportunities.

Moving to page 5, the macro environment. The industry growth drivers that we have described in the previous earnings calls continue to be fully intact. Digitization is changing networks and bringing the investment focus to the edge of the network. The edge is where you need to combine infrastructure knowledge with end-customer applications know-how, as we have discussed in the previous calls. It is where ADVA performs best, as a company we have aligned ourselves accordingly and invested exclusively in strategically important future technologies, technologies that enable new digital business models. In detail: Optical transmission technology delivers the required bandwidth. Physical and virtual edge technologies bring the cloud and related services closer to the customer and enable instant service creation with the click of a mouse, whereby packet solutions within this framework allow for secure cloud access. And our synchronization technologies guarantee the level of timing needed in a high-performance network. In addition to this positive backdrop around the demand for our networking solutions, I want to comment on two topics that influence the macro environment. First, Cisco announced its intentions to acquire Acacia. According to their public statements the main intention is to drive a tighter integration of optics within their switching and routing platforms. We see this as a confirmation that the importance of pluggable transceivers in our industry is increasing and can confirm that our initiatives in the space around our micromux have lots of traction. I will revisit pluggable optics and our micromux later in today's call. Cisco said that they will continue to support Acacia's current and new customers as well as their market model. At this point we see no impact on our ability to innovate and bring differentiated products to market, especially since we have multiple partners for each of our key technology pieces. As a side note it will be interesting to see if China will even give its approval for this announced acquisition. Which brings me to the second point. The current political tensions and disputes between the economic superpowers are increasingly affecting our industry and our company. Some of these ramifications present us with new challenges, others bring opportunities. For example, the trade conflict between the US and China generates higher tariffs and transport costs, putting pressure on our margins. The strong dollar adds to this pressure. On the other hand the decision of the US Administration to deny access to use these technologies to Chinese Telecommunications Supplier Huawei has changed the competitive landscape around the globe. Especially in Europe any communication service providers have large installed bases of Huawei technologies in their network. Our limited supply capability on the part of a Chinese giant would have an impact on further network expansion and supplier selection. However, Huawei's response to this new situation and the opportunities for us as a trusted partner and supplier in Europe is not yet completely clear. We will continue to monitor these events very closely in order to proactively address negative effects or capitalize on new opportunities.

Summarizing: Our industry growth drivers are fully intact, and our strategy and portfolio are well aligned. Our three core competencies are strategically relevant to the transformation of networks, a transformation based on openness, virtualization, security and precision timing. This creates new growth opportunities and new market segments. On the next three slides I will highlight some of the key accomplishments that we have made over the past few months. Essentially they're overviews of many of the projects and customer wins/announcements that we have made. Moving to slide 6, Cloud Interconnect. Our Cloud Interconnect solutions built around the FSP 3000 product line are doing well in a world which is moving to an open, disaggregated networking approach. We have possibly the best and most versatile open line system architecture and we have just come to market with a new generation of terminals. In addition, you will be seeing us also offering pluggable coherent Optics. Yesterday we announced that our new TeraFlex terminal broke several industry records in a terrestrial long-haul network. The performance of the product is compelling, and its market introduction is proceeding according to plan. The feedback from customers who have already tested the device is excellent and we have already had our first orders on hand shipped in Q2 and plan on scaling the TeraFlex in Q3. It is a powerful tool for our network operators to expand the capacity of existing network infrastructure, not only in DCI applications but also in terrestrial brownfield scenarios. We have announced several other interesting customer wins since our last earnings call, and the revenue contributions from our highly differentiated advanced link monitoring system, or ALM, and our micromux 10 by 10 small little optical plug that muxes up to 100 gig, are growing nicely, as can be seen on some of the wins on this presented slide.

Moving to slide 7, cloud access. The big picture. Our FSP 150 family, a packet edge solutions together with our ensemble software products, or NFV infrastructure products provide flexible and fast delivery of NFV based services at the network edge. More specifically the market response to the launch and the general availability of our new 100 gig aggregation platform, the FSP 150 XG480 has been extremely positive. We start shipping this quarter and hope to ship volumes in Q4. On the virtual side of the portfolio, our Ensemble Connector software has been certified for the Intel Select Solution for universal CPE applications. Equally important we announced a new partnership with DELL EMC, also for the universal CPE application. So we have one of the largest integrators as a partner and we have the largest technology provider for the virtualization of the edge of the network as partners today. Our universal CPE architecture is technologically leading and not only relevant for carriers, but also for large international companies that rely on system integrators such as DELL EMC for their global IT solutions. A new partnership gives us access to new markets and additional sales channels for the ensemble software. Furthermore, our Ensemble Activator Software plays a key role in the disaggregated cell side gateway, defined and promoted by the Telecom infra-project known as TIP that is receiving great interest in the mobile network operator community. And finally, I would like to highlight that we were able to win another application in the Openreach solution portfolio, the UK specialists for network access solutions uses our FSP 150GO102pro series as a network termination technology for the nation-wide launch of small cells. The compact cell site gateway with high-precision phase synchronization plays a key role in providing 5G mobile services in the UK. The 5G technology is starting to have a positive impact on our revenues and opportunities. We are expanding the differentiation of our market leading hardware portfolio and moving into higher margins with our technologically advanced software solutions and services offering.

Moving forward to slide 8, network synchronization. For network synchronization solutions our success rate for tenders remains very high. The Oscilloquartz portfolio is technologically leading and key products have been validated by the European Advance Networking test center, EANTC, for their IEEE 1588 precision time protocol, known as PTP interoperability in a series of tests focused on the new 5G timing requirements. We have also won a number of customers for 5G infrastructure roll-outs. Furthermore, we launched the industry’s first service for monitoring a satellite base timing that is powered by artificial intelligence, by using our software knowledge to offer solutions that help carriers deal with full picture solution sets, in this case it is all the timing coming off of the satellites. In addition, together with Nokia, we demonstrated an end to end 5G synchronization solution. As I mentioned already, the portfolio is a highly differentiated portfolio, growing 2X to ADVA average rate and we see interesting opportunities and new verticals. An optimized final slide no. 9 growth strategy and portfolio update, bringing it all together. As stated, our technology tripod is developing very well with each leg fulfilling an important role in the network transformation happening in every market segment. The much discussed introduction of 5G pushes the fiber deeper into the access area of networks. Corresponding, technological advances, such as IOT, and edge computing, also require a new innovative and scalable telecommunications infrastructure, with more efficient optical transmission technology, new virtualized models for service provisioning and more accurate network synchronization. The portfolio is precisely tailored to these trends, we are making progress on all fronts.

Let me summarize starting with the Cloud Interconnect in the upper right-hand corner. Our new TeraFlex terminal is shipping. Performance and customer feedback are excellent. We have started to take orders and we see new opportunities, not only in DCI but also in carry infrastructure. Our differentiated advance linked monitoring system, known as the ALM and our micromux plug are opening new doors, expanding our application space and delivering growing revenues and higher margins. In the Cloud Access space, we are expanding the differentiation of our market-leading hardware portfolio around the FSP 150 and moving into higher margins with our technologically advanced Ensemble Software Solutions. Our universal CPE architecture is best in class, best in the industry and we have won many accounts already. And with Oscilloquartz, our network synchronization portfolio, we use our technological leadership to gain market share and expand into new verticals. Win rates are very high, now also in Latin America, which was a challenge for us to begin with, leading to revenue growth in excess of our standard revenue growth. I am excited to see the high win rates, with new generation products that will ultimately also help to support stronger margins. And with that I hand over to Uli for the finance performance section. Thank you very much.

00:18:35 Uli Dopfer

Thank you Brian, welcome everybody and thank you for joining our Q2 conference call. I will review our second quarter results and also our view on Q3. As Brian stated in the beginning of this call, revenues in Q2 2019 amounted to 133.2 million EUR and were 7.6% up from 123.8 million in Q2 2018. This result is within our guidance of between 130 and 140 million EUR. Gross profit contribution increased to 46.5 million, up from 45.4 million in the year ago quarter. Our pro-forma operating income margin was at 3.3% of revenues, down from 5.0% in Q2 2018. This result is near mid-point of our guidance of between 2 and 5% of revenues. Net income was at 1.3 million EUR compared to a net income of 4.6 million EUR in the year-ago quarter. Consequently, earnings per share decreased from 9 cents to 3 cents. Without considering IFRS 16, net debt in Q2 2019 improved to 31.9 million EUR compared to 36.6 million in the year-ago quarter. The implementation of IFRS 16 explains the overall net debt increase of 31.5 million to 68.1 million versus Q2 2018.

Slide 12

Our revenues grew sequentially by 3.9% and 7.6% year over year. The increase in revenue is driven by solid demand from all customer groups in all technology areas. With 4.3 million EUR or 3.3% of revenues, we were able to improve our pro-forma operating income sequentially both in absolute and relative terms. Compared to the year-ago quarter, pro forma operating income decreased by 1.8 million EUR or 1.7% respectively. We are pleased with the sales development, however, our margins in Q2 2019 were behind our expectations. This was mainly due to the strong US dollar and additional costs resulting from international trade conflicts. In order to respond to the current margin pressure resulting from before mentioned challenges, we are taking additional measures to reduce our operational costs. On the positive side, our order intake was very strong, and we are entering the third quarter with a well-filled order book. We see promising projects and activities in all regions and among all customer groups, pointing to a strong second half of the year.

Slide 13

Quarterly revenues per region. EMEA revenues increased by 24.7% year over year, now representing 53.3% of total revenues. We are traditionally strong in this region, leveraging our well-established partner landscape and our reputation as a trusted supplier to a broad and loyal customer base. The Americas region contributed 39.1% of total revenues, in particular business with network operators developed well in this region. Asia Pacific continues to be dominated by project-based business, leading to quarterly fluctuations. Asia Pacific now represents 7.4% of total revenues.

Slide 14

Balance sheet ratios. Q2 2019 credit matrix remains solid with an equity ratio of 47.8%. We improved our gross leverage to 1.2 due to a stronger operating cash flow and increased loan repayments in Q2. Financial debt of 116.3 million EUR consists of liabilities to banks of 80.1 million and IFRS 16 related lease liabilities of 36.2 million. Year to date ROCE was at 1.9% and networking capital was at 23.9% of sales.

Slide 15

As already mentioned in the past, our operating cash flow is subject to a certain seasonality due to recurring events in particular employee-related costs in Q2 and Q3. Compared to the year-ago quarter, we were able to increase our operating cash flow significantly by 21.5%.

Final slide

As Brian stated, the growth drivers for our industry are fully intact. Digitization is changing the networks and bringing the investment focus closer to us. Our three core competencies are strategically relevant to the transformation of networks and we have a high win rate with our new products, contributing higher margins. We have a strong order book going into Q3. Our positive revenue development continues. Margins in Q2 were behind our expectations, primarily due to the strong dollar and the additional costs resulting from international trade conflicts. In order to respond to current margin pressure, we are taking additional measures to reduce our cost base. For the current quarter, Q3 2019, we project revenues of between 135 and 145 million EUR with a pro-forma operating income margin of between 3% and 6% of revenues. Overall we remain committed to the positive outlook for the current fiscal year. Thank you and operator please open the Q and A.

00:26:15 Simon Scholes (FirstBerlin)

Yes, good afternoon. I have three or four questions if I may. Firstly I was wondering to what extent you are seeing momentum behind the establishment of local data centers at the network edge? And then another momentum question, I was wondering what momentum you are currently seeing behind 5G related ordering. Then on NFV, besides the Ensemble platform, I was wondering to what extent the NFV topic is increasing the proportion of software within your revenues. And fourthly, on Huawei, I was wondering if you could comment on potential down sides for ADVA from Huawei's response to US sanctions.

00:27:17 Brian Protiva

So, I think I am going to take most of that. And that is, the first one's local DCs. Clearly local DCs, it is fundamental to our vision, our strategy and our business long term, and that is, we believe the cloud's going to be pushed, you know, to begin with centralized and then it moves out to the metro and to COs, central offices and then all the way out to the very edge of the network. It will be driven to the enterprise, it will be driven to the mobile, network outs (?) with things like MEC. And it even is driven out for the IOT infrastructure. So we see that as an ongoing business opportunity. We are investing heavily in that. We are the definitive leader right now in the local, when it looks like from an enterprise perspective on premise, little data center that can host applications. So again, it is fundamental to what we are doing. We think it is moving forward quite nicely, you see massive investment also from the big cloud titans in this particular space. And then you have a lot of the carriers and some local providers feeling that this is their opportunity also to compete with the cloud titans, due to security, locality, datenschutz, what is it, data protection of individuals and things like that. So a very interesting market space for us. It is driving some business, not as much as we would have anticipated looking back 12 and 24 months ago, but it is the future. It is coming. Transformation in the carrier space takes time, and therefore we have to be a little bit patient.
Second question is 5G ordering is influencing us already. We are winning deals. We are upgrading existing customers; we have a very nice architecture to address it. I think we have won a number of the synchronization and timing bake-offs that relevant for 5G. We have won some of the mobile infrastructure pieces as well. We named Openreach this time around. And we have built and architecture that we believe encompasses optical packet, NFV as well as sync and timing to be differentiated. I think we are one of the very, very few, if not the only one that can offer all of those technologies in some form or combination to address 5G and therefore we think we can expand our market opportunities through those 5G ramps. Clearly, right now, most of the spend is in infrastructure, most of it is some RAN (?) investment and leveraging existing 4G type of infrastructures out there. It is just starting. Everybody is trying to bring up and say we are 5G cable or whatever, but it is just starting. Most of the spend is in licensing but it is going to ramp and over the next three years it going to be a very interesting business for us.
The third question was NFV and yes, it has some, because some of the NFV and the centralization of EPC and some of the other applications out there, it is happening as we speak. It is driving band width over the network. So it continues to help provide applications and bandwidth to drive optical infrastructure. Point one. Point two, yes we have our own NFV infrastructure solution steps and we are driving that into the market. Relatively low revenues, it is one of the areas we are investing heavily in and we will continue to focus on that opportunity. It doesn't have much direct influence on our revenues today, but I would say in 24, 36, 48

months it will have a rather large influence. I think the industry as a whole has hyped both SDN and NFV, it has taken longer than expected, but they are fundamental technologies that are fundamental for transformational change and the carriers to virtualize the networks become more flexible, more scalable, less dependent on personnel and operational costs, so it is going to happen.
And the final question was wrapped in around Huawei and I have always been wary in our calls to say 'oh, this is great for us' because we do not know. It is a very powerful company. And sure enough, I think Huawei is reacting aggressively in some accounts, so we share some accounts with them, and they have been aggressive in some of these accounts because of what has happened. So there is opportunity coming our way in certain customers deciding they don't want to work with Huawei, but at the same time on the other side we have more competitive pricing pressures on some other accounts. I think it is a wash right now and that's what I have been saying, I said that is not one of the areas I am looking at to go drive our business, but it is not needed either. We share many accounts with them already. They are rock solid. They are not going away. I think we are in a tide of ups and downs because I do fundamentally believe that the US and China will agree at some point in time in the trade conflict so again, it is not something that we are strategically pushing and it is both a positive and a negative for us right now.

00:33:00 Simon Scholes
Okay, thanks very much.

00:33:09 Robin Brass (Hauck&Aufhäuser)
Good afternoon. Also one question from my side especially concerning the US market, North American market. How do you see the dynamics here, from a demand perspective? How is the evolution going here especially for your products? And also, from a competition side? Generally, so how does the competition currently acting and also related to this second question would be how do you see the acquisition of Acacia, for your business and also for the whole market in general?

00:33:38 Brian Protiva
From a demand perspective I see the US as a good market for us. We are doing well. They are clearly very open minded when it comes to technology leadership. So if you were to look at some of our newer products, we are gaining traction there, often first and winning infrastructure opportunities, software opportunities etc. We are broadening out our customer base. I very much like to see what is happening there. From a competitive landscape, clearly, Ciena is the big kid on the block. And then you have the Ciscos, Nokias, Infineras, kind of the others that we compete with on a regular basis. I think clearly Infinera is still a little bit wounded, so we have to watch closely to their pricing strategy and what they do, but I think it is a fairly normalized competitive environment and technology matters. We are leading with technology and as many of you know we've invested very aggressively to … we believe transformation is coming in our industry and we have invested very, very, aggressively in R&D, PLM, BD in order to position new products in every one of our tripod areas accordingly and those new products are leading to strong positioning in the North American market. Now we just have to realize that, push that through, conclude on some of the opportunities we are working, move forward.
Second question on Acacia is … we have been moving to balance that dependency for the better part of 18 months and I think we have a very nice strategy in place to balance that. I think of anybody out there we are probably the least dependent because we aren't in the long haul where they are truly differentiated, for us, we are not in that market space as a number one market target. Having said that, if you see our announcements from yesterday, we have the best, best data, best backed, best distances available, so Acacia is a market leader in their space, they are an important supplier to us, but we have alternatives. Point one. Point two is Cisco has gone out of their way in writing to commit) that they will not change the business model, that they are committed. Having said that, clearly, how does Cisco act in two years? Do they price accordingly that we can use Acacia DSPs and compete? That will be a question, but this will not impact any of our longer-term commitments. Anything that we have on market today, even the kind of next things that we are working on at all, because we have commitment pricing support services on all the pieces. So this is not something that is a short-term issue for us but we will continue to monitor it and manage it very closely, and honestly, I am still not certain that this even goes through. I just continue to believe China, unless they do a major trade negotiation assault, all of it, I just think ZTE is in bed with Acacia as well and there will be push back on this because it is supporting one of the large Americans, I just think with the push back that America has done to the large Chinese that there will be lots of jumps and flips in order to make this deal even happen. But having said that, I am not too worried about it, we just need to manage it and move forward.

00:37:14 Robin Brass
Okay. Thank you, Brian.

00:37:39 Sascha Seiler

Hi there, thanks folks. Firstly, on the cost measures that you mentioned, I would be curious to know what steps you take at the moment and you can also remind me how your manufacturing footprint looks, whether there is some potential to take out some costs there. And a second question would regard to this trend of vertical integration in general, whether you think it makes sense for you to also look into vertical integration or whether you want to basically still be independent of any component business?

00:38:25 Uli Dopfer

Alright. Thank you Sascha. This is Uli speaking. So, cost measures, yes, we are looking at several options what we can and what we should do. Clearly what we realized is that the mentioned pressure on the gross margin will not go away any time soon. So, as said, we are going to react to this, we have identified certain pockets within our organization where it makes sense to drive costs out. Clearly, where we need to be careful, and we are saying this all the time, is we have to be careful that we do not jeopardize our opportunities for the future. So we are going a fine line here, not taking the momentum out of the company, of all these wins that we are having, of all the future wins we will have, of all the products we have on our roadmap. On the other hand we understand we need to get more efficient drive cost out and this is what we will do have had certain ideas, many ideas, and we will execute soon.

00:39:33 Brian Protiva

Adding to that, a couple of things. From a manufacturing perspective we have actually had costs go up and that is because of short term issues, things like the trade conflict, which is costing us money, a couple of million this year, we are managing that, we are trying to manage that down but it is real dollars for us, real profitability, real dollars and at the same point as these things come and surprise us, we are having to drive things like freight, air freight, rapidly get products into a market because of potential trade duty that is going to be imposed, costing us lots of money. So, there, it's … we are in this seven-digit as well, so you have some of these issues in manufacturing, that will be neutralized we believe as we, we have counter measures in place. Whether the trade negotiation goes well or not, we are not being dependent on that, we have a strategy in place to move out. If they then solve it, we can leave certain things in, but we have a plan to manage that effectively, and stability in the manufacturing model helps us. So I think it has gone up, relatively, I think it is actually going to come down into, for the next 18 months, naturally, with some of the efficiencies but yes, we are also driving consolidation and cost optimization in manufacturing throughout. But like I said, it is up for now, coming slowly down already and optimizing over an 18-month period of time. From an R&D perspective, one can imagine, you know, we have really spent a lot of money in getting products to market. Huge amounts of money. So those markets, most of our new products are at market now. They are there, we are starting to sell them stuff. So, we can also there manage investment costs very effectively. You know, looking at the big picture: we have the revenue growth, our margins are low because of a number of issues, some of them we can't influence, some of them we can, but that, to us, we are very much focused on things like cost reductions and a plan to increase our margins with some of the new products, the software contracts, the services, it is all happening as we speak, so that should help us address that margin piece and then at the same time as Uli said that OPEX piece needs to be driven down because we are at a stage right now where we have done a lot of the heavy lifting, we are moving into market, we can optimize, we did three significant acquisitions over the last five years. There are further things that we can make sure we are managing extremely efficiently. So, as tough as the margins have been for us, and clearly we have a plan in place in two areas, one is margin expansion the second is OPEX management that I think that we can do quite well in over the next period of time and essentially things like capping OPEX, flat OPEX over a longer period of time, we can do that without, as Uli says, impacting our competitive position and/or the opportunity that we are pursuing.

Last question was the vertical integration piece and that is absolutely, we are starting to realize, and in fact we are selling to some of our competitors vertical integrated solutions. You will see us get a lot more active with that positioning over the next maybe six months, where we are starting to expand the vertically integrated product portfolio and even market that more aggressively externally. So you will see us doing more there. We have an outstanding team. We do it very efficiently. We are leveraging outside resources; we don't have to build any infrastructure. And I feel very positive and upbeat about that opportunity because we are already having some successes there.

00:43:36 Sascha Seiler

Thank you.

00:43:48 Stefan Klepp (Commerzbank AG)

Yeah. Hi everyone. I appreciate you taking my questions and I understood all what you said about the cost measures you are taking and with the price pressure and the margin upside. The only thing that is missing here is some quantification a little bit, in my opinion. So when you talk about price pressure on the one hand, so you say that your Chinese competitor is very aggressive in Europe at the moment and that is impacting you and in the US obviously, things are not looking up due to the US dollar, at the same time you are saying you have new products out there where you can realize higher margins, so what is the net-net effect of all of that and what kind of cost measures, I mean, yeah, what kind of cost measures reducing OPEX, you said that many times, but can you quantify that and where should that leave us net-net, looking into 2020 when even probably more of your latest equipment be shipped where you should have a higher margin. So, can we probably talk about that from a numbers perspective? Thank you.

00:44:39 Uli Dopfer (?)

Brian, did you want to start with the Huawei topic?

00:44:42 Brian Protiva

So, first of all Huawei is not the one that's … we said that there's some positives and negatives, we share some accounts, they've gotten aggressive in some things, but I don't think that is fundamental to our margin issues. I think there again the quantifications, we have low brutto margin in Germany it is called, you know gross margins in the US and it is quite low on a … you look at multiple quarters back to back to back, and we feel that we are going to turn that and slowly increase that again with a combination of our cost reductions and the new product introductions into the market. What is hard to quantify for you is, what if the dollar goes to 1,08? I sit here and quantify, we think we can increase it by, you know, 0.5% per quarter over the next six quarters and the dollar course, because the dollar has really hurt us, probably close to 2%. Probably. It is a hard model to look at. We buy a lot in dollars, we sell in pounds, we sell in euros in a big way and so it does hurt us. Our planning was at a much different layer than it was, or level than it was today and therefore it is not easy to give you a quantifiable, but I do believe that dollar being stable that we can increase that quarter for quarter over the next four, five, six quarters always with considering product and customer mix. So, step by step on the margin expansion. On the operational cost expansion, I think I already made my comments, Uli and I are aligned, and that is, you know, Q2 needs to be net capitalization effects. Q2 needs to be our standard and we've always been increasing our operational costs as a company, investing in more products, in more things and I think we can cap that for a longer period of time. And that is our goal is to clearly, the CFO and CEO of the company completely aligned OPEX and what we then need to do is grow the top line, regardless of anything else, our numbers get better, but the upside is that we really can leverage the new products, software, services and maybe even get lucky with the dollar. Or the trade tension issues and the costs that are coming from other places.

00:47:17 Stefan Klepp

Okay, I got all that. And I know it is hard for you to estimate but in the end, you have a new product out there, the TeraFlex product, which is the fastest in the industry and you are probably, as you said yourself, have good sales on the back of that. At the moment we have very good momentum anyhow on the sales perspective, but nothing is coming through and the mix, we don't see that at all at the moment. So if you assumption that the mix in the next two to three quarters is helping and OPEX, you see rather developing flat, is that what you are saying at the moment?

00:47:49 Brian Protiva

I think what we commit to, is that we are growing in the top line, feel really good about Q3, feel good that we can, second half of this continue to grow like we had said in the upper single digit growth range. The market seems to be supporting that into next year, there is no indication at all with 5G and some of the investment dollars that are coming down the pipeline, so feel good about the revenue number. Feel good that we can control the OPEX spot on, that is Uli and my responsibility at this point and we have started. I mean there are things happening to optimize, since a month or since two months, so we are saying okay, we are bringing all those products now, we can start to pull in the reigns and we are doing that work as we speak and then from a margins perspective, yes, the new products definitely will help us to expand margins, but the fact is that's a really much harder one to call for you today. My personal feeling, it is not a company feeling, is that, yes, we can increase, and that over the next six quarters, gradual increase, quarter for quarter as we sell in our new products, services and software, more aggressively out there and footprints that we have won and are going to win. But I can't sit here and give you an exact number on the margins. Having said that, even if the margins were stable and we do growth plus OPEX, we are getting better.

00:49:02 Stefan Klepp

Can I ask another question? With regard to the sales perspective and sales momentum. With the new TeraFlex product, okay, you said you've got it shipping in Q2, feedback is good, Q3 is looking great, so do you think the momentum is still building? Do you see it only at a starting point at the moment and we should see the big growth in Q4 and through the start 2020? Is that right to assume that?

00:49:23 Brian Protiva

I would say the TeraFlex will be an evolving product that is growing quarter for quarter for many quarters to come. And we have the breakup scenario if we win the large cloud titans with a product like that, but I have always said that is the breakup scenario. We are going to compete for everything. But TeraFlex should be a very nice product that evolves. Some shipments in Q2, more shipments in Q3, viable revenues that start to help us in Q4 and then a really strong product for 2020. That is the way I would view the TeraFlex, with breakout scenarios if we add certain large customers. The technology, very, very competitive, the software infrastructure on the product, very, very competitive, we have all those pieces put there. Many things that go into winning strategically large customers. That is how I would frame TeraFlex today.

00:50:37 Stefan Klepp

Okay, thank you.

00:50:41 Mirko Meier (LBBW)

Thank you, a couple of questions, mostly for Uli. I would like to come back to the weaker margin in Q2, you mentioned the dollar, but you also mentioned the weaker revenue mix when it comes between products, categories and customer segments. Could you share some put in takes between those? That would be great. And then you also mentioned one project where you have to push off the revenue recognition. Could you explain what that means? Is the project just postponed? Or is it totally skipped? And the reason behind and the volume would be great. And when it comes to Asia, in Q2 the revenue dropped to a single digit range, a level we last saw in 2017, without MRV. Have you lost some key player at MRV, so the cross-selling is no longer working or has something gone wrong with the integration? And then the cost numbers – the sales and marketing are very heavily … What is the reason behind that increase? And once again to the new TeraFlex product. You mentioned that the tests are going well, and you also have some orders on hand but no revenues in Q2, is this right? And then the last question for your margin guidance in 2019. Previously you guided for a margin higher than level in 2018, which was 4.6%. Now you are guiding for mid-single digit. Is this a lowered guidance or have you just opened the range a bit? Thanks.

00:53:00 Uli Dopfer

Let’s start with the US dollar revenue mix impact, and so on. So Brian already said that the US dollar costs us growth margin and increases our OPEX base. So if you, just as a rough idea, if you compared our Q2 2019 with Q2 2018, if we had the same US dollar, we would probably have half a million more gross margin. Then we have the impact from the trade war, the increased tariffs are also Q2, if you want to compare it with Q2 2018, it is also between 300 and 400 K, so you have alone almost 0.7, 0.8% gross margin, lower gross margin compared to the previous year. The customer mix, that is something that always impacts us, and you know our business is partially project driven and how projects fall, how they get recognized. You can have a big swing in a quarter from one quarter to the other. That is clearly one impact, there are stronger margin projects, depending on the region, depending on what project it is. Is it an enterprise project, is it a carrier project, the margin levels are different and that is why you see the change in the margin? Let’s see, the other question was related to the not-recognized project. So I cannot give you an exact number, but it is several million that we shipped. We were just not able to recognize the revenue, there are certain rules when you can recognize revenue, there has to be an acceptance from a customer. The network has to be up and running, we have done our part and this project for sure not skipped, because we have shipped, and it will be recognized within Q3. The next question regarded Asia Pac, maybe you want to comment on that one, Brian or if I should?

00:55:26 Brian Protiva

So I think it has nothing to do with the integration, it has nothing to do with the product focus or concentration, it has to do with particularly one customer that is taking a break because of local market dynamics. Point 1. Point 2, because of inventory levels. If anything we are stronger than ever at that customer. We are replacing one of our large competitors and another application and hope to have some contributions coming again in Q4, hopefully a strong 2020, maybe not as strong as our 2018, but a strong contribution coming from them, which would then help the Asia Pacific number as a whole, clearly. But I don’t think it is because of lack of execution on our part, but more customer specific situation that has led to that situation.

00:56:28 Uli Dopfer
Okay, then I take the next question regarding the selling and marketing increase, cost increase. Actually you should be really excited about that one, I say this because most of our sales force – the salary is variable, or a big portion of the salary is variable and this reflects essentially the increase in sales and marketing costs reflects our strong order entry and our strong momentum that we have, because we have to pay high variables for the sales team.

00:57:03 Brian Protiva
The other aspect of that is we are investing in sales in 2019 because we have the products. We need to go sell them and win footprint.

00:57:22 Operator
Are you questions answered, Mr. Meier?

00:57:25 Meier
No. The last one. I have two open questions, one was the TeraFlex about revenue in Q2, if there are any? And the margin guidance was a question.

00:57:38 Uli
We have not recognized any TeraFlex revenues in Q2, we always said first shipments in Q2, first recognition in Q3. So there is no recognition of revenues of TeraFlex in Q2.

00:57:49 Brian Protiva
But we had orders and we shipped products.

00:57:57 Mirko Meier
And the margin?

00:58:04 Brian Protiva
Sorry, I had the question asked in the background.

00:58:09 Mirko Meier
The last question was regarding your margin guidance for 2019, previously you guided for a higher margin than 2018, that means roughly 5% you want to reach. Now you have skipped this guidance and now you are guiding for mid-single digit. So what implies that it could also be a margin below 2018 margin? Is it right that you have lowered your guidance or are you just opening the range of possible margin you will receive?

00:58:49 Brian Protiva
My understanding, and Uli correct me if I am wrong, is that we had always said high single digit growth, mid-single digit for pro forma EBIT, but our intent was to beat last year. That was our communication, so we said mid-single with intent to beat last year. And I think our comments today are that we still believe that we can be in the mid-single digit range for 2019. Uli, correct me if I am wrong.

00:59:26 Uli Dopfer
That is absolutely correct, this is what we said. And clearly we are shooting to exceed 2018 in absolute and relative terms.

00:59:37 Brian Protiva
But clearly at this point we would have to meet the high end of Q3 and have a break-out Q4 in order to do that, but I think we still feel confident in our second half and therefore we are reiterating the mid-single digit guidance, but with challenges to beat the high four percentage from 2018.

01:00:19 Stephan Rettenberger

Thank you everybody for joining today's call and the active dialogue and Q and A. We will be back in touch with our Q3 numbers late in October.