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00:00:02 Operator

Welcome to the conference call of ADVA Optical Networking for the 3rd 2019 IFRS Financial Results. This call is being recorded. After the presentation there will be an opportunity to ask questions. I now hand you over to Mr. Stephan Rettenberger, ADVA Optical Networking's Senior Vice President, Marketing and Investor Relations, please go ahead, sir.

00:00:42 Stephan Rettenberger

Thank you and welcome from my side. This earnings call builds on a presentation which is available for downloading in PDF format from our homepage under www.adva.com in the folder /investors section. If you do not have the presentation in front of you, you might want to access it on the conference call page in the financial results section of the investor section of our website. Before we lead you through the presentation, as always please be informed that this presentation contains forward looking statements with words 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 Q3 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.

00:02:45 Brian Protiva

Thank you Stephan, let's move to page 4, Q3, 2019 in review. Q3 revenues reached EUR 144.3 million, up nicely by 14.4% year over year from 126.2 million in Q3 2018. Our Q3 pro forma operating income was at EUR 7.4 million or 5.1% of revenues. Both key performance indicators were at the top end of our guidance corridor, provided on July 25, 2019. We continue to see solid demand and are pleased with the level of order entry, while the demand for our solutions is very healthy, the challenges around a strengthening US dollar and the US China trade tensions, with related costs, continue to put pressure on our margins. We have taken measures to counteract these effects, which we will explain later in this presentation. Nevertheless, most importantly, our win rate with recent technology investments is very high, allowing us to realize higher margins in our new market segments. Our achievements here further underscore a momentum and the confidence in the market.

Slide 5, industry macro environment. The industry growth drivers, which we have described in the previous earnings call, 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 application know-how. As a reminder, it is where ADVA performs best. We have started to see 5G gaining momentum. Slowly but surely it will become a reality. Several mobile operators have announced the start of their 5G services, and the new network build-outs are in process. We have already benefited from a number of strategic synch and timing wins in 2019. A substantial part of the 5G infrastructure will be served in a wholesale model where our portfolio fit is perfect. In addition, the need for tighter synchronization and compute resources at the edge of the network play well into our technological concepts for both the transport and packet edge infrastructure. As a company, we have aligned ourselves with the upcoming network requirements for having all the key technology pieces to address edge networking for 5G infrastructure. Beyond 5G, open networking, disaggregation, the virtualization of the edge and edge computing are all fundamental for the digital transformation, which we have all been tracking and discussing as an industry over the last few years.

Our technology builds the foundation for this transformation, a foundation that is driving automation, supporting the move to the cloud and ultimately increasing productivity within all verticals and all customers. This positive backdrop around the demand for our networking solutions is unfortunately overshadowed by geopolitical tensions. Even within this context, I want to reiterate: Our industry growth drivers are fully intact, and our strategy and portfolio are well aligned. Our three core competencies are strategically relevant and important. On the next three slides I will highlight some of the key accomplishments we have made over the past few months.

Moving to slide 6, cloud interconnect. Our cloud interconnect solutions built around the FSP 3000 product line are designed to deliver a most effective terabit transport with great levels of security and ease of use. The solution architecture is leading in terms of its openness and doing well in a world that is moving to a disaggregated networking approach. We have possibly the most versatile open line system and leading-edge open terminals. This is not only about building the right hardware solutions, but having the flexible, open software with the right APIs and the ability to support agile development requirements from our customers. Speed and flexibility are key. In more detail: Last month, industry analysts from Ovum confirmed our market leadership in the enterprise DCI, the Data Center Interconnect. Where our native protocol support and certified encryption technology make a big difference. With a global share of 30%, 47% in EMEA, we continue to expand our success as a trusted partner for security sensitive mission critical infrastructures. With our new TeraFlex terminal we have further proof points of unparalleled spectral efficiency, boosting the capacity of existing optical networks, so-called brown field applications. The performance of the product is compelling, and the market introduction is proceeding according to plan. We are in the process of scaling our volumes of the TeraFlex. As a reminder, we have the best and most flexible architecture on the market, enabling us to offer up to 1200 gig, 1.2 terabit super channels today. In addition, we have the ability to adapt to any optical line side infrastructure and map the most efficient modulation scheme with our fractional modulation capabilities and any bit rate to optimize for the highest bandwidth over the longest distance. We are years ahead of the competition, although they will not admit to this presently and are trying to use fear and uncertainty to slow our market penetration.

Moving to slide 7, cloud access, our second area of competence. Our FSP 150 family of packet edge solutions together with our Ensemble Software products provide flexible and fast delivery of NFV based services at the network edge. From the beginning of the year, we have seen a phenomenal acceptance rate of our ensemble connector software. A network operating system that converts a bare metal server into a universal customer premise equipment, or short universal CPE. A majority of carriers' requests for proposals, short RFP, are explicitly asking for NFV-based universal CPE solutions. We see proof points that Ensemble Connector is the market winner. It is the right product at the right point in the cycle. Besides the publicly announced wins you see on this curve, we have also won a significant number of additional accounts that still have to be named, or made public. In addition to the success of our software solutions I want to highlight that our FSP 150 pro-series, a programmable packet edge device, which is a significant amount of interest in the context of a wholesale network infrastructure for 5G. The products provide very good solutions, where operators seek to deploy edge compute facilities for latency sensitive IOT applications. In general, our FSP 150 IP and Carrier Ethernet products are very competitive, based on having introduced new aggregation and CPE/NID architectures over the last 12 months. All in all, we are expanding the differentiation of our market leading hardware portfolio and we are moving to higher margins with our technologically advanced software solutions.

Slide 8, network synchronization. For network synchronization solutions, the third area of competence our success rate for tenders have been very high for several quarters. The Oscilloquartz portfolio is technologically leading and supports the transition of radio access networks to 5G. In addition to the use case in the network infrastructure for the mobile network operators, the portfolio is now ready to expand into other industry verticals. Our synchronization technology is enabling the rollout of so-called 'fiber deep' architectures in digital cable networks as we distribute precision timing to the remote fiber devices more efficiently than ever before. The financial services industry is migrating from network time protocol, known as NTP, for time stamping, to PTP, where our Oscilloquartz solutions are technologically superior. The server farms in geographically separated data centers need to be tightly synchronized, independently of GNSS signals, driving the demand for our atomic clocks. And most recently in Q3, we added functionality to support the requirements of power utilities and broadcasting networks. With our investments in synchronization technology, we expand our total addressable market, increase ADVA's value proposition and relevance in the networking industry while ultimately further accelerating our growth in higher margin markets.

And with that my summary slide 9: Portfolio growth opportunities summarized. Edge computing solutions, IOT and 5G require a robust and scalable telecommunications infrastructure with more optical transmission capacity, new models providing communications services, and more precise network synchronization. Our technology investments address precisely these aspects. Our FSP 3000 platforms sets new standards in open optical transmission technology. The platform efficiently delivers automated scalable data transmission that further reduces the cost of terabit transport. Our market leadership in enterprise DCI and the compelling feature set of our new TeraFlex open terminal allow us to drive success in the segment. Our packet edge solutions with Ensemble software provide flexible and fast delivery of NFV based services at the network edge. The market acceptance of our mature enterprise edge compute solutions has dramatically accelerated in 2019, laying a solid foundation for software revenue growth. The need for edge compute solutions in the 5G framework, to address low latency applications fuels additional growth potential. In addition, we have enhanced the end to end packet edge solutions, our FSP 150 product family, with aggregation, higher layer protocols, timing and temperature hardening. We are prepared for 5G transport and IP solutions. Our synchronizations solutions portfolio is technologically ahead of any competitor and is actively used by many of the world's leading network operators. We have made further investments in the portfolio to expand our addressable market and enter new industry verticals. We will continue our growth trajectory and profitable business development. Throughout 2019, our technology tripod has gotten stronger and many of the technology investments of the last years have been transformed into highly competitive product offerings enabling us to grow high single digits in the fiscal year and providing us with a solid foundation for 2020. And with that I would like to pass off to Uli.

00:16:15 Uli Dopfer

(Slide 11) Thank you Brian. Welcome everybody and thank you for joining us on our Q3 2019 conference call. I will review our Q3 results and also our view for Q4. As Brian stated at the beginning of this call, revenues amounted to 144.3 million euros and were 14.4% up from 126.2 million euros in Q3 2018. This result was at the upper end of our guidance of between 135 and 145 million euros. Gross profit contribution increased to 49.1 million, up from 47.3 million in the year ago quarter. Our pro forma operating income margin was 5.1% of revenue, down from 5.4 in Q3 2018. This result came in towards the upper end of our guidance of between 3 and 6% of revenues. Net income was 2.2 million compared to a net income of 3.9 million in the year ago quarter. Consequently earnings per share decreased from 8 cents to 4 cents. Q3 2019 net debt, without the adoption of IFRS16 was with 38.7 million at the same level we saw in Q3 2018. Including the IFRS16 adjustment our net debt was 74.9 million. Except of revenues, all our key financials are significantly impacted by the US trade dispute on which I will elaborate further on the next slide. Next slide please.

(Slide 12) Our revenues grew sequentially by 8.3% to 144.3 million. We are pleased that the strong pipeline we saw at the beginning of the quarter materialized, driven by solid demand from all customer segments and technology groups. The effects of the US trade dispute, however, had an increasing negative impact on our business. A significant portion of our products are manufactured in China and are denominated in US dollars. Thus, the increasing tariffs, as well as the strong US dollar negatively impacted our business, resulting in a gross margin of only 34% in Q3 2019, versus 37.5% in the year ago quarter or 37.9% in Q2 2019. With 7.4 million, or 5.1% of revenues, or pro forma operating income improved strongly versus the 4.3 million in Q2 2019. Compared to the year ago quarter, pro forma operating income increased by 0.6 million. Excluding the US tariff impact, our pro forma operating income would have been 2 million higher and 6.5% of revenues. In the third quarter of the financial year, our revenues continued to develop well. However, since the profitability remains below our expectations, we initiated several actions to streamline our supply chain and to limit our overall spend. Let's move to the next slide please.

(Slide 13) First off, we are moving significant portions or our production out of China, to limit our exposure to US tariffs. Secondly, throughout Q3, we expedited the transfer of materials and components to US locations to reduce the negative impact of further increasing import duties. The shift resulted in increased freight costs and high inventory levels but will help our profitability going forward. Finally, we are strictly controlling our operating costs. We are progressively invested in innovation and technology in recent years and quarters and develop many important products. We are now in the position to consolidate some of our R&D efforts without jeopardizing our competitiveness. We are streamlining our footprint. We are reducing headcount selectively and we are managing discretionary spending aggressively in order to optimize our cost base and to improve our profitability. These measures will save us approximately 26 to 30 million euros until the end of 2020. Some of these measures led and will lead to one-off costs. Next slide please

(Slide 14) Quarterly revenues per region. EMEA revenues increased significantly by 27.9% year-over-year, now representing 53.9% of total revenues. Based on stronger demand from a number of customers in North America, especially from the communications service providers, revenue increased nicely by 18.3% compared to Q3 2018, now contributing 38.5% of total revenues. Asia/Pacific continues to be dominated by project-based business, leading to quarterly fluctuations. This region now presents 7.6% of total revenue. Turning to the balance sheet now, next slide please.

(Slide 15) Q3 2019 credit metrics remain solid with an equity ratio of 48.1%. Gross leverage at 1.2 indicates a solid investment grade profile. Liabilities to banks of 77 million and IFRS lease liabilities of 36.2 million add up to our total financial debt of 113.2 million euros. ROCE was at 2.4%. We invested more in our working capital mainly to mitigate the effects of the higher US tariffs. This impacted our cash position in Q3, but will benefit us in the quarters to come. Our gross cash came in at 38.4 million and our net working capital was at 24.1% of sales at the end of Q3 2019. Next slide please.

(Slide 16) 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 Q1 and Q3. Special effects impacted our Q3 cash flow negatively by 3.5 million euros, but reached a similar level compared to the same quarter last year. Next slide please.

(Slide 17) While changes in the global economy currently impact our profitability, revenues continued to develop in a positive manner. Growth and profitability are our key objectives and we took initiatives to keep our business on track. Despite several countermeasures taken, the uncertainties about the US trade disputes, as well as the final outcome of Brexit remain challenging and might have further impact on our future numbers. However, for the current quarter, Q4 2019, we project revenues of between 142 and 152 million euros and pro forma operating income margin of between 5% and 7% of revenues. We remain committed to the positive outlook for the current fiscal year and continue to invest all our energy and creativity in innovative solutions for the benefit of our customers, shareholders and employees. With that, operator, please open the Q&A.

00:24:11 Operator

Thank you very much. Ladies and gentlemen, we are now starting the Q&A session.
The first question is from Simon Scholes, First Berlin. Your line is now open.

00:24:49 Simon Scholes (First Berlin)

Yes. Good afternoon. I have two questions, if I may. The first is on your cost development where cost discipline is clearly evident in sales and marketing, general admin and R&D. They are respectively below 11%, below 6% and below 20% of sales in Q3, which is some way below what they have been in recent quarters. So, I was wondering if you can maintain these cost items at this percentage of sales, providing revenues remain buoyant over the next quarters. The second question is: you mentioned that your pipeline was very positive at the beginning of Q3 and the promise of that pipeline was fulfilled. Can I assume that the pipeline is similarly promising at the beginning of Q4? And that that promise is being fulfilled?

00:25:52 Uli Dopfer

So, I'll take the first question, regarding the cost development. Yes, we try to maintain that metric, even though, maybe even improve it with increasing revenues. I guess during the last earnings call we made the statement that we try to keep our operating costs, excluding any effect from the R&D capitalization, as flat as possible, and we are committed to that, to do everything to be there and as you said, if the revenues increase, then the metrics should become even better.

00:26:22 Brian Protiva

I think we have said our goal is to keep that flat over six quarters at least and allow things to catch up, compensating for some of the challenges on our gross margin due to the effects of the dollar and China trade war, etc. I'll take the second one and that is: pipeline Q3 was good going in. I think when you talk to our operations and sales teams we feel secure also in moving into Q4, otherwise we wouldn't be guiding 142 to 152 million, which would indicate that business is strengthening into Q4. So we feel good about the environment, it's day-by-day in our industry, as we all know, but we like what we see, and we have got to keep pushing.

00:27:11 Simon Scholes (First Berlin)

Okay, thanks very much.

00:27:18 Operator

The next question is from Felix Lutz, Frankfurt Main Research, your line is now open.

00:27:24 Felix Lutz (Frankfurt Main Research)

Good evening, gentlemen, hello, thanks for taking my question. On the projects you expect in China, or you say there is project business, do you have a timeline when these projects will come? And you have a cost position for restructuring costs of 2.4 million in your pro forma EBITDA. Where does this come from and what could we expect in Q4 and maybe in 2020 for one-off costs related to a restructuring of the operational business? Thanks.

00:28:09 Uli Dopfer

Alright, Felix, we don't have any project in China. I guess what I said, we have project-based business in Asia/Pacific. I guess you may have misunderstood. So, is that clear now?

00:28:28 Felix Lutz (Frankfurt Main Research)

Okay, that is clear.

00:28:30 Uli Dopfer

The second one regarding the one-off expenses in Q3 was about close to 2.5 million. The majority was related to severances and partially to facilities. For Q4 I would expect a similar amount. Most likely in the same range. And no further plans for now as far as it comes to one-offs for 2020.

00:29:03 Felix Lutz (Frankfurt Main Research)

Thank you. Maybe I have a follow-up. Can you give a picture of the client concentration in the US with the new products? Where is it going? More to the ICPs? And maybe you would have a higher capitalization rate in the R&D, maybe you could give some information on this as well. Thanks.

00:29:37 Brian Protiva

Oh, with the US business, I think we sell into all three segments efficiently and effectively, and that is, we have ICP business, we have the service providers and we have enterprise business. I think all of them are doing quite well, specially some of our larger customers have continued to build out business with us and therefore

America is growing, and we believe actually going into a good phase, especially with our competitive new products.

00:30:14 Uli Dopfer
Regarding the capitalization, actually the capitalization rate is down slightly and also in absolute numbers the net effect of the capitalization went down compared to the previous quarters, so I don't know what you are looking at.

00:30:33 Felix Lutz (Frankfurt Main Research)
I have to check it. Okay.

00:30:37 Uli Dopfer
Please start to check and come back (00:30:39 unclear) …

00:30:42 Felix Lutz (Frankfurt Main Research)
… so there are no changes expected from the capitalization rate?

00:30:46 Uli Dopfer
So the capitalization rate will go down or will be around that range, however, amortization will increase over the next quarters. We always said the impact on our pro forma EBIT will be close to zero towards the end of the year and I guess this is the way we are trending right now.

00:31:05 Felix Lutz (Frankfurt Main Research)
OK. Thank you.

00:31:10 Operator
The next question is from Tim Savageaux, Northland Capital Markets, your line is now open.

00:31:22 Tim Savageaux (Northland Capital Markets)
Hi. Good morning from me, at least. I think that was me. A couple of questions and first, overall, congratulations on some very solid results on, depending where you look, a pretty volatile looking environment. My first question is on, you mentioned Brian, a 1200 or 1.2 terabit capabilities or 600 gigs per wavelength. I am wondering if you are seeing here any material revenues for those solutions that describe the pipeline that you see heading into Q4 and into next year. And kind of as a side note to that, whether you are seeing any impact in the market competitively from any emerging 800 gig solutions?

00:32:13 Brian Protiva
We have some pretty cool stuff in our TeraFlex, being able to support the (00:32:18 unclear) super channels. Whether you use one or two wavelengths, it is less dependent, we can use wavelengths that are right next to each other or pick wavelengths with any kind of a frequency range accordingly to build those super channels, so I think, it is available today, we are moving forward with it as a company and a number of our customers really like what we offer there. Point one. Point two, we do not see any competitive threat in any of the RFPs or the projects we are working on from any 800 gig-based solutions today. I am sure that there are pricing exercises in existing customers and market share where our competitors are trying to push 800 gig technology and pricing, let's say, modelling that is not based on their existing technology, but on future-ware. That clearly is happening, but I think we are very well positioned to compete effectively. So, really like our offering, things are doing really well in the field trials and some of the PoCs (note: proof of concept). I think it is an area where we are going to win market share over the next twelve months.

00:33:46 Tim Savageaux (Northland Capital Markets)

Great. And if I might follow up: for Q3, overall, really solid double-digit growth there, but pretty volatile underneath the hood, right? Some pretty nice, strong growth in EMEA and particularly North America and declines in Asia/Pacific. I wonder if you could maybe dig a little bit deeper on what the growth drivers were in those regions, well, in EMEA in particular, focusing on overall market growth versus share gain, potentially. And then, as you look at your Q4 guidance, are there any similar dynamics in terms of regional or geographic growth or declines that you can call out, either sequentially or year-over-year. Thanks.

00:34:42 Brian Protiva

I think it is high level, first of all. We are doing these numbers and this growth even though two of our top customers have definitely taken a break due to some of the things that are going on internally within their organizations. One of those customers is in Asia/Pacific. It was a large customer of ours. I think we are very well positioned at that customer, but volumes aren't strong and therefore it is affecting, along with the project basically, and the project dependency in APAC, our numbers, some. It starts to recover, and Asia/Pacific should be growing into next year and we should start getting quarter for quarter steps forward in Asia/Pacific. Having said that, strong EMEA and strong US, I think bandwidth growth in general, investment dollars into clearly beginnings of 5G, all important, and maybe more fundamentally, is we are winning market share, we are winning market share with our new products which is healthy for growth. We are winning new customers, our win rate at new customers is really strong, we are not losing many, yes there is price competition out there, but I think ADVA probably hasn't ever been better positioned with our product portfolio than we are today. So, you ask how that evolves into Q4, I am looking forward to the competitive environment, I believe ADVA has never been better positioned, so let us go compete for building infrastructure needs of our customer base. And what we are hoping clearly is that the industry relevant issues like investing in bandwidth growth, like investing in 5G, it seems like all segments are investing aggressively because the network is at the heart of productivity gains, you know, automation and all the things we are talking about in the digital transformation, that that outweighs some of the economic challenges that the world seems to be facing. So far, so good, fingers crossed that again industry specific issues, service providers have to continue to invest, enterprises are selectively investing in areas that make a difference and allow them to drive digital transformation, that they continue to move forward. And of course the ICPs, the ICPs big dollars and most likely getting bigger over the next years. And therefore, we are confident and also hopeful that our industry as a whole doesn't get influenced, like many other industries are being influenced right now.

00:37:35 Tim Savageaux (Northland Capital Markets)

If I could maybe follow up on that just briefly and then I will hand it over. You mentioned a couple of carriers sitting on the sidelines, Asia/Pacific, we've also, you that is a specific reference to Deutsche Telekom, but certainly they have slowed down a lot, at least in terms of access spending, and have historically been a pretty big customer for you guys, which is, you know, I think even more impressive to grow through, but my questions is, do you see any kind of recurring themes or kind of rhyme or reason with regard to carriers and seemingly a decent number of them, I don't whether it is, you know, looking at post spectrum purchases or options or looking at architecting, fiber aspects of 5G networks and just kind of taking some time in the back half of 19 to evaluate that before moving into 20, or would you look at some of this sitting on the sidelines just, kind of, random and uncorrelated?

00:38:40 Brian Protiva

So, I guess my view is, optical networking is a different animal than broadband access. You go through major upgrades in the access networks and they come to an end at a carrier. If you are exposed to a number of carriers and they are in sync, you can have highs and lows, more, let's say, volatility in that, in a segment. Having said that, there are fewer competitors. So our challenge is there are more competitors, there is always the pricing velocity is very high in our industry but getting better, the consolidation is happening, you know, we still have nine competitors out there but there are very few that are profitable and healthy, essentially, but in general, I think the optical network is based a little bit better. That bandwidth is growing every day. Yes, you have some roll outs where it starts and it ends at a carrier, very rarely are they in sync across an industry or even a region or even within a country. So, it is much more staggered. I think, you know, the second carrier that, you mentioned one in APAC, is not in EMEA, so that answers your questions and I believe that, you know, again, we are in an industry that shouldn't have huge ups and huge downs. Having said that, we are in a very competitive industry, but what you need for that is innovation and, you know, the ability to price competitively and I think, we have those things to do well in our industry.

00:40:16 Tim Savageaux (Northland Capital Markets)

Okay. Thank you.

00:40:22 Operator

We have no further questions for the moment.
There are no further questions. Ladies and gentlemen, thank you for your attendance. This call has been concluded.

00:40:49 Stephan Rettenberger

Okay, then thank you everybody for joining today's earnings call. We will be back with our Q4 earnings then in February 2020. Thank you and bye-bye.