Transcription

ADVA Optical Networking, Full Year 2019 IFRS Financial Results

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PRESENTATION

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Dear ladies and gentlemen, welcome to the conference call of ADVA Optical Networking for the full year 2019 IFRS financial results. This call is being recorded as a reminder. All participants will be in a listen only mode. After the presentation, there will be an opportunity to ask questions. May I know hand you over to Mr. Stephan Rettenberger, ADVA Optical Networking Senior Vice President, Marketing and Investor Relations. Please go ahead, sir.

00:00:45 Stephan Rettenberger

Thank you and welcome from my side. This earnings call builds on a presentation which is available for download in pdf format from our home page under www.adva.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 self section of the investor section of our website. Before we will lead you through the presentation, as always, please be informed that this presentation contains forward looking statements with words such as beliefs, anticipates and expects to describe expected revenues and earnings, anticipated demand for optical networking solutions, internal estimates and liquidity. These factors are discussed in greater detail in the risk reports section of our annual report 2019, which we published today. Please also be reminded that we provide consolidated performer financial results in this presentation solely as supplemental financial information to help the financial community make meaningful comparisons with our operating results from one financial period to another. This performance information is not prepared in accordance with IFRS and should not be considered a substitute for historical information presented in accordance with IFRS, performer operating income or losses, calculated price and 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 to provide a business update and outlook. Then Uli will talk us through our Q4 and full year 2019 financials. And finally, we will have sufficient time for your questions, which we will be happy to answer. Brian, please go ahead with the business update.

00:02:58 Brian Protiva

Thank you, Stephan. So, page 4 of the presentation, Q4 2019 in review. We finished the year strong. Our Q4 revenues reached €151.1 million, up nicely by 14.9% year over year from 131.5 million in Q4 2019. This also represents nice sequential quarterly growth. Our Q4 performer operating income was at €10.3 million or 6.8% of revenues. Both key performance indicators are at the top end of our guidance corridor provided on October 24th, 2019. On an annualized basis, our revenue grew by more than 10%, an excellent result that even exceeded our communicated annual goal and was supported by us meeting the lower end of our targeted profitability. The lower end of profitability, due to dollar and trade related cost pressures. Furthermore, we continue to see solid demand from all regions and customer groups. We have a good order backlog and we are pleased with the level of order entry across the portfolio. Our newer products are enabling us to expand into new markets where the demand for our solutions is very healthy. The challenges around a strengthening U.S. dollar and the U.S.-China trade tensions with related costs, continue to put pressures on our margins. Thus, we are committed to continue our tight control of OpEx throughout 2020. Our Q4 results and 2019 achievements further underscore our momentum and our confidence in the market for 220.

Slide five. Industry: Macro Environment.

The industry growth drivers, which we have described in the previous earnings calls, continue be fully intact. Multi-cloud concepts for enterprises, edge computing solutions for network operators, IoT and 5G all require a robust and scalable telecommunications infrastructure with more optical data transmission, new models for the provisioning of communications services and more precise network synchronization. Our investments in recent years address precisely these aspects. We are technologically well positioned for the new opportunities of this network transformation, a transformation based on openness, virtualization and security. As we position ourselves over the last years, 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 within customer application knowhow. It is where ADVA performs best and is most differentiated. This positive backdrop around the demand for our networking solutions is unfortunately overshadowed by geopolitical tensions and the US tariffs on goods coming out of China, both of which have had an impact on our 2019 margins. More recently, we have started facing new topics, creating uncertainty caused by Covid-19, the corona virus. The city of Wuhan is an important center of photonic components and subsystems, and the isolation of the region is causing delays in the global supply chain and more specifically will start impacting our ability to supply products in the coming weeks. More detail on these last two aspects will be covered on my next slide.

But even within this context, I want to reiterate our industry growth drivers are fully intact and our strategy and portfolio are well aligned. Orders are healthy, and we even had record bookings in Q4, 2019. Most importantly, our three core competencies are strategically relevant and important for evolving network architectures.

Now moving to Slide 6. Operating Model Adapting to a Changing World.

As our operational model is an area of uncertainty, as seen by our ad hoc pre-announcement, I thought I would take some time to help you understand our operations strategy. In the areas of manufacturing, logistics and distribution ADVA has developed a tightly integrated approach with best in class global Tier 1 EMS partners and a very strong operations team to manage these strategic relationships. The production process, and degree of automation, have been optimized over many years to drive operational excellence, quality and cost optimization. Our global EMS providers manage a large part of the operational value chain from material purchasing to PCB manufacturing and then final hardware assembly, after which they support us with software loading, functional testing and ultimately the distribution logistics. Co-located ADVA experts monitor the results of the individual production and testing steps using remote shop floor control systems, which we have designed and produced. Ultimately, it is critical to ensure efficient communication between ADVA's development centers and these manufacturing partners. This model allows us to scale quickly and to be flexible in times of challenges. Our distribution strategy to support global business is built on our own distribution centers in Europe and the US. We continue to fine tune and to strengthen both staging and configuration competencies within our centers, and we are very focused on further improving efficiency in freight and logistics, by working closely with our global EMS partners. On the manufacturing side, we had to make changes to mitigate the impact of US tariffs on goods coming from China. We rapidly transferred finished goods to our distribution centers prior to the October 2019 deadline and have started to transfer production lines out of China to strategically reduce the dependency. These mitigation measures are ongoing and will give us an improved cost base for our US business starting in Q2, 2020. Disturbingly, the COVID-19 crisis is adding another dimension of complexity. Again, the city of Wuhan is an important center of photonic components and subsystems, and the isolation of the region is leading to delays in the global supply chain. It is currently difficult for us to assess what impact the crisis in China will have on our Q1 2020 results. We expect that despite the healthy order backlog, some of the order fulfillment and revenue recognition will shift from Q1 2020 to later quarters. Clearly, if the COVID-19 crisis continues for a longer period of time, we will have to review further changes to our manufacturing EMS partners by moving production to new sites. This is a time consuming and costly exercise for us, but we have already started a similar process with respect to the trade tariffs, last year. So where are the opportunities for growth?

Moving to Slide 7: Cloud Interconnect Growth Opportunities.

The strategic importance of reliable, global and highly secure communication infrastructure is rapidly increasing. The most important raw material here is fiber. It is the only medium that can satisfy the insatiable demand for more bandwidth. Fiber optic networks are extending their reach into new areas and are of crucial importance for 5G. Our transmission technology, in turn, ensures that this valuable medium is used optimally. Thanks to our FSP 3000, network operators can sustainably cope with the rapid increase, increasing amounts of data being transmitted. In 2019, we were able to gain share in the market for metro WDM. Based on industry analysts' numbers published in November 19, our Q3 results moved us to the number two position in EMEA and our Market Leadership in optical networks for data center interconnect (DCI) for private companies increased to greater than 50% in EMEA and greater than 30% globally. In addition, our numerous major carrier customers worldwide began using our technology to expand their networks in preparation for 5G.

The trend towards open solutions is disruptive here. Network operators are driven to decouple the individual building blocks in their networks in order to use innovation cycles more flexibly. In addition, in times of geopolitical tensions, they can reduce their dependency on individual large suppliers with open solutions. As a pioneer in the development of open and interoperable solutions for several years, ADVA is benefiting from this trend. Our FSP 3000 sets new standards and open optical transmission technology. The platform delivers highly automated, scalable data transmission that further reduces the cost per bit of transport. The market introduction of the new TeraFlex terminal has been successful and the flexibility of our open line systems OLSs has potential to push market dynamics further in our favor. And finally our efforts towards more vertical integration create additional upside.

Moving to slide eight: Cloud Access Growth Opportunities.

For many emerging applications in the digital world, it is important how and where the three critical functions of data processing, storage and transfer interact. For the Internet of Things, IoT, and also for the creation and use of artificial intelligence, the efficient collection, processing and provisioning of data is of crucial importance. In this context, edge computing solutions are emerging that require data transmission with low latency and high security, or I should say, highest security. The network operators investment focus is therefore moving closer to the network edge and towards our sweet spot. At the edge is where ADVA is best positioned. For many network operators Carrier Ethernet access technology is a key part of the technology mix at the network edge. We have successfully consolidated this market segment in recent years through the acquisition of Overture and MRV and are now one of the two leading manufacturers in this technology space, worldwide. Network operators are currently upgrading their Carrier Ethernet access networks and increasing data rates from 1gig to 10 gig. And for this, they need new demarcation and 100 gig aggregation technology. Smaller manufacturers are finding it increasingly difficult to keep up with the high pace of innovation and are falling behind technologically. As a result, new opportunities are emerging to gain market share. In addition, the trend towards virtual provisioning of value-added services is accelerating. Our ensemble connector offers flexible and fast provisioning of NFV-based services at the network edge. Several leading network operators, as well as system integrators, have selected a solution as a key component for their universal customer premise equipment. Our win rate over the past year has been impressive and commercial implementation of this software solution will continue to gain momentum in 2020.

Slide Nine: Network Synchronization Growth Opportunities.

And our final part of our tripod. I want to briefly touch on this pillar, network synchronization technology. Network operators worldwide have embarked on a journey of implementing 5G and therefore need higher precision time and phase synchronization in their networks. Our Oscilloquartz portfolio is globally recognized as the leading technology architecture. Its range of solutions offers unique features and achieves very high success rates in tenders around the globe. After an already very successful 2018, we were able to increase the revenue contribution of this technology pillar in 2019 with strong margins. In additions to the increasing demand from network operators, the product portfolio now also addresses timing applications and other industries such as media and energy utilities. The vulnerability of GNSS signals or the timing that comes off of satellites is causing concerns as more and more applications rely on precise timing. Network operators in charge of mission critical infrastructure are rethinking their synchronization strategies and shift towards network-based timing, rather than exclusively relying on satellites or GPS timing signals. Since H2, 2019 our investments in synchronization technologies are now starting to return invested euros as the segment is growing faster than 20% per annum. We are on the verge of annual profitability in 2020 in this market segment. And finally, in addition to accelerating 5G rollouts, we see additional opportunities for growth and profitability in new industry verticals.

Slide 10, and my last one. A summary of why we win and why we are growing in a world driven by cloud and mobility. We are committed to our brand promise of open networking, operational excellence and being a partner who is easy to do business with. We were the first of the optical networking vendors to push open solutions, alien wavelength support, open optical line systems and we have moved beyond this to offer open universal CPE solutions and the CSG software, so that is the access, same cell site gate access routers at the edge of the network. Our commitment to operational excellence will help us not only continue to lead in sustainability, but also solve our latest challenge with a COVID-19 supply chain chaos, while, for our customers, we will remain a leader in open, transparent communication and products. However, and most importantly, it is our passion to remain focused on our customers' needs and be the easiest company in our industry to work with. With this, I pass off too Uli to cover our financials.

00:18:26 Uli Dopfer

Thank you Brian. Welcome everybody and thank you for joining us on our Q4 and full year 2019 conference call. I will review our results followed by our outlook for 2020. All numbers are presented in euros. We executed the financial year 2019 successfully with revenues of €556.8 million, 10.9% up from €502 million in 2018. The positive development was due to solid demand from all customer groups across all technology areas. Our pro forma operating margin was at 4.5% and on a similar level with 2018. Our margins in 2019 were heavily impacted by the US dollar development and the effects resulting from the US trade policy. The strong US dollar compared to 2018 contributed negative €3.2 million. Costs related to extra tariffs and additional freight costs resulting from transfer of materials and components to US locations amounted to €5 million. We were able to offset these costs, these effects due to our cost discipline within optics. I will discuss the current status of our improvement measures at a later stage. Due to the first-time adoption of IFRS 16, net debt increased significantly to €61.1 million. This includes €34.4 million lease liabilities. Excluding IFRS 16, net debt was €26.7 million and at a similar level compared to the €26.8 million at the end of 2018. We met or exceeded all our expectations for the financial year 2019.

Next slide, please. Q4, Key Financials.

As Brian stated in the beginning of this call, revenues in Q4 2019 amounted to €151.1 million, and was significantly up by 14.9% from €131.5 million in Q4 2018. This result was at the upper end of our guidance corridor of between €142 and €152 million. Pro forma cross-profit contribution increased to 54.6 million, up from 48.7 million in the year ago quarter. Our pro forma operating income margin was at 6.8% of revenues, up from 6.2 in Q4 2018. This result also came in towards the upper end of our guidance of between 5 and 7% of revenues. Net income was 2.5 million compared to 3.6 million in the year ago quarter. Please note that our Q4 net income was impacted by 3.2 million, one-off restructuring expenses. Consequently, earnings per share decreased from 7 cents to 5 cents. Net debt was at 61.1 million, as already discussed on the previous slide.

Next slide, please. Q4 Revenues per Region

Looking at our revenues geographically, EMEA revenues increased by an impressive 22.5% year over year. Now representing 53.9% of total revenues. This is attributable to a very good demand from network operators as well as strong business from enterprise customers. We also saw solid demand in North America similar to EMEA. We had strong business with all customer groups. North America revenues increased significantly by 11.4% compared to Q4 2018 now contributing 38.3% of total revenues. Asia Pacific represents 7.8% of total revenues. The region is predominated by project-based business, leading to greater fluctuations in individual quarters. In addition, regulatory uncertainties affected one large customer, which led to a decline in revenues with that particular customer.

Next slide, please. Quarterly Revenue and Pro Forma Profitability.

Except for Q1 019 our revenues grew sequentially throughout the year. In Q4, we were able to convert successfully the strong order pipeline into revenues. Based on a more favorable customer mix, pro forma gross margin increased to 36.1%, up from 34% in the previous quarter. With 10.3 million or 6.8% of revenues, our pro forma operating income improved strongly when compared to the 7.4 million or 5.1% in Q3 2019. Compared to the year ago quarter, pro forma operating income increased by 2.2 million.

Next slide, please. Improvement Measures. Status Update.

We are pleased to see that our improvement measures are showing the expected results. The transfer of tariff affected production lines from China to Southeast Asia will be completed within Q2. To limit the negative impact of further increasing import duties, we expedited the transfer of materials and components to US locations. This resulted in before mentioned increased freight costs and high inventory levels in the second half of the year. We are making good progress with our product roadmap, which allows us to streamline our R&D efforts without jeopardizing our competitiveness. Our targeted cost savings of €8 million in 2019 have been achieved and will lead to run rate savings of up to €22 million. This supports our aim to keep OpEx flat on an annual basis.

Turning to the balance sheet. Q4 2019 credit metrics remain solid, with an equity ratio of 47.7%, gross leverage was 1.2, indicating a solid investment grade profile. Liabilities to banks of 81 million and IFRS lease liabilities of 34.4 million add up to our total financial debt of €115.4 million euros. Year to date ROCE was 3.3%. We were able to improve gross cash to 54.3 million, up from 38.4 million in Q3. I will discuss our cash flow development for the financial year 2019 on the next slides. The networking capital for Q4 improved strongly to 21.4% of revenues at the end of Q4 2019 and improved by 2.7 percentage points compared to the previous quarter.

Next slide, please. 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. Operating cash flow improved year over year by 8.9%.

Next slide, please. Free Cash Flow, 2019.

We made big steps forward in many areas within the financial year 2019. However, free cash flow generation was not one of them. Our free cash flow decreased by 5.7 million down to €6.6 million, mainly impacted by the high investments in new products within our technology tripod. Focus investment areas were: enhancement to the open optical transport solution, including the development of the new TeraFlex terminal and a new generation of open line systems. A new generation of 100G Network Edge products, including our NFV software for our cloud access portfolio and ultra-precise synchronization technologies for 5G mobile networks and other industry verticals.

Next and final slide.

We have created a solid basis in all three technology areas and see promising growth scenarios as a result of the network transformation that is disrupting all markets. The market introduction of the new FSP 3000 TeraFlex terminal have been successful and the flexibility of our open line system has the potential to push market dynamics further in our favor. Several leading network operators, as well as system integrators, have selected our NFV solution as a key component for the universal customer premises equipment. Our win rate over the past year has been impressive and commercial implementation of the software solution will continue to gain momentum in 2020. Our investments in synchronization technology are bearing more and more fruit and offer us additional opportunities for growth and profitability. Due to the COVID-19 crisis in China, our supply chain is temporarily constrained. We believe that this will most likely lead to a negative pro forma operating income margin in Q1 2020. Whether and to what extent the situation in China will change cannot yet be reliably predicted. However, we assume that some revenue will shift to the following quarters and that the decline in proforma operating income margin will recover on an annualized basis. Finally, we stay committed to work diligently on our OpEx to improve margins. We decided to change the revenue and profitability guidance from quarterly to annual period. For the full year 2020, we expect revenues to exceed 500 *(NB: the correct value, as stated on the slide and mentioned in the Q&A is 580)* million euros and a pro forma operating income margin above 5% of revenues. With that, I hand the call back to the operator to open the Q&A session.

Q&A

00:30:20 Stephan Klepp (Commerzbank)

Yes. Hi, Stephan Klepp actually, but anyhow. So, hi, guys. Just a few questions from my side. Q1 is going to be not good because of the supply side disturbances. Any indication how bad Q1 will be and any visibility on the improvement? Do you think it's going to be Q2? And last but not least, you said that the bookings in the fourth quarter were at record level. Can you give us more color on that? Because record levels can be anything.

00:30:55 Brian Protiva

So I will take the first point, you take the second point, Uli. The first one is in and around what's happening in China. And it is a moving target. We are getting updates daily, weekly. The latest information is that Wuhan as continuing to shut down the factories, could be all the way and to the tenth of March at this point. So it is a moving target, day by day. It seems like the numbers that we are being fed, looking that things are stabilizing. Having said that, I think it's just a matter of, you know, waiting that out. And then as we get information, we will forward that the best we can to our investor base. I think at this point, we are truly flying blind and I think a lot of companies are. I mean, looking at some of the car companies, looking at Apple, I think a lot of them are being surprised by the situation. I do think we can catch up pretty quickly, though, as we get going. I would hope to do it in Q2. I think we can't commit to that today, just because we don't know how long, how much, but I believe we will catch up pretty quickly. And usually the Chinese community and especially manufacturing community is very focused, very committed, willing to work overtime, willing to work in multi sessions. I think once we are released and moving forward, we will be able to recover pretty quickly.

00:32:32 Uli Dopfer

Okay, so I take the next one, the question regarding the regarding the bookings. Usually we don't disclose booking numbers, but I can tell you that the bookings in Q4 exceeded by far the revenue we posted for Q4. So I don't know if I can give you a percentage, maybe about 20% roughly. So a nice uptick. However, this, of course, also includes some multi-year service contracts, so don't expect that this will translate immediately into revenues in one of the following quarters. So some of the over achievement in bookings was due to multi-year service contracts. Which again, because, you know, it makes us sticky and binds us with the customers and shows that we have a longer-term relationship with these customers.

00:33:25 Stephan Klepp (Commerzbank)

Can I come back to the first one? Is it right then, to assume that your supply was, let’s say, disturbed or started to get disturbed two weeks ago and since then you were not able to ship anything, or more or less in an extreme scenario? Is that right to assume? Are you saying that actually? Because …

00:33:43 Brian Protiva

… No …

00:33:43 Stephan Klepp (Commerzbank)

… everything in contract is (00:33:44 inaudible)

00:33:45 Brian Protiva

No, so, I think we showed you a slide in our manufacturing strategy. We were not just solely dependent on China. We have already moved some pieces out because of the trade conflict. We also had most of our optical products outside of China. So what we are assuming right now is that there was exposure of about 40 million of products. It could have an impact, but we had a lot of supply chain organized and planned and stuff. The look, right now, is somewhere between 10 and 20, you know, and then depending on orders, how they flow, how big of an impact that is. There are a lot of variables that just, because of all those variables and because of that range, and it's, again, a best guess right now. It was just too complicated for us to go out there with a massively wide range and then have an update that week by week. And therefore, you know, we decided to pursue the strategy of the annual number. And we do continue to believe that annual number because we ended the year pretty strong, as early had indicated. We think we have good new products, things, though, running well in the in the markets for us. And therefore, we feel confident. But clearly, lots of uncertainty. And it's just not something we can quantify for you today. So we will be back and close to you guys over the next weeks and months to try to help you understand that as we understand it. And I think that is really the best we can do. But it is not a black or white. It is that we are exposed to a certain number of our products. Some of the components, though, create complexity because, oh, could that have an impact? You know, a customer doesn't want a partial delivery, etc. So lots of moving parts.

00:35:39 Stephan Klepp (Commerzbank)

Okay. Thank you.

00:35:55 Tim Savageaux (Northern Capital Markets)

Hello there. And a couple of questions. You know, I guess I would like to try and, if I think, I heard you right, it is 10 to 20 million revenue impact for the year out of the CVs. So you are guiding to, I guess, 5%. Plus tight growth for the year with that impact. I wonder if you could kind of relate that guide both to the strength of your performance in the second half, you are seeing some slowing there, but the overall levels of market growth, really. And if you could kind of segment commentary on both the optical and enterprise side, if there is any meaningful difference in growth rates, both for your Q4 performance and for your 2020 outlook. Thanks.

00:36:50 Brian Protiva

So first, it is not a 10 to 20 million yearly, that was a quarterly comment. Clearly, all the numbers I mentioned in the first thing were quarterly. We are exposed to the Wuhan area, if Wuhan stayed closed for the whole year, we would start a transfer policy and try to pull things out, get another site, you know, for certain key strategic products going as quickly as possible. So it is not a yearly issue at all. We believe that we catch up that 10 to 20 million rather quickly, unless the scenario is that Wuhan stays shut for three to six months. In that case, we would most likely go, restart some of the pieces in other regions and get that going and then we'd recover some of that piece in the second half. So we can't comment annually, we can't answer the question on Q1. There is no way we can quantify what the actual impact is from our annual level if Wuhan stays shut. Never will happen, but I am just trying to put that into perspective. So that is the first area. And again, we think it is temporary and we think they are going to come back stronger than ever. And yes, we are already in a process of transferring stuff out because of trade tensions. And it means, that we continue down that strategy to get really good balance throughout 2020. I also indicated, though, that is not a free lunch, that is a lot of hard work. It means huge focus on our operational teams. And if you reduce volumes and certain things in one region and move to another, you need to manage that well from a cost perspective. So that's that answer. The second was about market growth. I mean, you get that data, Tim, from the markets and I think people are saying that the market is growing, depending on who you're talking to, anywhere from 3 to7%. Some of the bigger players are saying it is 4, 5, 6% market growth rates out there. Some are saying, not very positive at all and especially some of the large players in the core routing segments. So, it really depends on who you are talking to. I would say, because of the uncertainty at the start of the year with a couple of these issues for us is that we have said, okay, we look good. We were growing much faster last year. Clearly, that could have some annual impact for us. And we feel that getting 5% growth and 5% pro forma EBIT is the right strategy and the right forecast for us. When you look at breaking that down into segments, in uncertain times the carriers are not good customers from a margin perspective. They put a lot of pressure on their suppliers. But in uncertain times they are pretty stable. So I guess that is the only comment I can make there. I don't think one market is growing radically faster and if any area is growing relatively faster, that is the ICP space. I don't think that the enterprise space versus the carrier space in our product segments is growing fundamentally faster. A lot of people said that the enterprise segment would start to decline as the ICP, and service provider space dominates. I don't see that shift happening either. And important for ADVA is that we continue to bring products to market that allow us to address all three segments efficiently. So in the enterprise space, sync and timing is now becoming an opportunity for us, which is important for us. Universal CPE is an area that we are targeting enterprises with. So we are building products that are targeting those market segments.

00:40:42 Tim Savageaux (Northern Capital Markets)

Great, and if I could follow up quickly. You mentioned ICPs as perhaps a faster growing part of the market. As you look at what appear to be a pretty broadly positive demand environment in Q4 and your strong bookings, can you call out whether cloud providers were a meaningful part of that and maybe in tandem with that, what you are seeing and what you might have seen in terms of 600 gig or higher type products driving order bookings in the quarter.

00:41:20 Brian Protiva

So high level, I think, ICP was a good quarter for us. I mean, nothing fundamentally changing where one area is growing. I think Uli precisely said, most market segments and most regions, we are doing fine across the board. So not one to call out, but yes, we are doing fine in that ICP space. Remember that is only high single-digits for us, to a low double-digit type of range from exposure perspective. So, I think that is the one issue. What was the other question now? Ah, 600 gig, so, yes, I think that continues down the pipeline. We are competing for a number of things. I think the competition seems to have pushed off their introduction of the 800 gig. The products are … big iron. So it is slowly but surely moving into, let's say, our customer base. And then there are some big opportunities that we continue to pursue there. It is an important product for us, an important part of our 2020 plan. But we are not forecasting massive growth. We think we are very competitive throughout the year. And as we have indicated, we think we have some features and capability in the products that people don't even catch up to with their latest, or next gen products.

00:42:54 Tim Savageaux (Northern Capital Markets)

Okay. thanks.

00:43:09 Simon Scholes (First Berlin)

Yes. Hello. I have two questions, if I may. The first is on 2020. It looks as if it is going to be another busy year in terms of tariff saving initiatives and cost control measures. I mean, I noticed you had about nearly 6 million in restructuring costs in the 2019 numbers. I wonder if you could give us a rough idea of where you currently budget 2020 restructuring costs to come in. And secondly, I know there is a great deal of uncertainty surrounding the situation in Wuhan, but presumably I would be correct in assuming that if Wuhan does stay in quarantine into Q2 of this year, in the current guidance you have given would be vulnerable.

00:44:05 Uli Dopfer

I take, definitely, the first one. So we plan restructuring of about one to two million, so not quite as high as last year. As I said, we follow through on our roadmap and we make good progress on our development roadmap and we continue to stream some of our R&D efforts. But the majority has been already done last year.

00:44:25 Simon Scholes (First Berlin)

OK, but I mean, the actually impact, it looks it is going to be higher this year.

00:44:30 Uli Dopfer

No, I think the saving impact is because you roll forward the (00:44:35 inaudible, multiple speakers) because you have a full year effect.

00:44:38 Simon Scholes (First Berlin)

Yes. Okay. Understood.

00:44:41 Brian Protiva

And I guess from a, I mean, yes, if Wuhan goes on for six months, we will struggle then with our annuals. But on the other side of the coin, you know, Shenzhen is up and running now with 20, 30% capacity. It was shut down. It's running now. And discussions are in place as to how do they get Wuhan up and running? That is one aspect. We don't see it lasting that long. That is not our information at this point. Second is, yes, we would start to transfer, you know, second leg for any key products that we have in Wuhan where we have suppliers or supply chain challenges out, and we were already actually started that process, nonetheless. So we are on it. And I think we would be able to manage that. Now do we recover everything? We could recover everything, even if we were down for three months or four months by having a stellar, focused approach in the H2. The real question there is, do we have any areas where we challenge customers to the point where we lose demand? As long as I think the industry runs into some similar challenges and it is not a non-issue at all. If others say I don't have any exposure at all to Wuhan, which I can't imagine because there are some key optical components coming out of there, and subcomponents and therefore we really need to look at the details on that. But yes, our guidance is context with Wuhan at some point opens up in Q1 or, you know, first half of Q2 kind of an area. And I think then we can regroup accordingly and meet all the needs of our customers and also our guidance. But again, they are moving parts. We have got multiple plan in place. I think we manage the trade challenge really, really well. I mean, you guys don't see all the things that happened in the background. We would have been highly exposed to that and by the end, we have really managed that well. And by Q2 2020 now, we will be in a really good shape to kind of stabilize most of those extra costs. We will do the same thing on this. We will manage it accordingly.

00:46:52 Simon Scholes (First Berlin)

Okay. Thanks for that. And just a quick follow up. You mentioned Shenzhen. How important is Shenzhen for you relative to Wuhan? And how serious was the virus outbreak in Shenzhen?

00:47:06 Brian Protiva

So Shenzhen, if you look at the numbers, it is like 415 people have been impacted. Only one death versus Wuhan where you are in 40, 50 thousand people and 1,500 deaths. So I think it is much more isolated. I think, you know, things are under control. We have our team up and working in Shenzhen. Yes, there are very strict regulations. Who can come in, when they can come in, masks, all sorts of … not travel by public transfer, et cetera, et cetera, so, it is really amazing how controlled things are in China. But I think it is the right approach for the situation. So we feel that Shenzhen is in decent shape. Like I said, they are up to now 20, probably more like 30% capacity and growing, step by step up. So feel comfortable there. Shenzhen is even more probably important to us than Wuhan because all of our Carrier Ethernet products are there. But I think, you know, so that that comes up and takes away some of the risks that we had in some of the numbers that I had mentioned. But let's see how that evolves. Positive right now. We will see step by step.

00:48:19 Simon Scholes (First Berlin)

Okay. Thanks very much.

00:48:33 John Lopez (+ Federate News)

Hi. Thanks so much. I am sorry, I just wanted to come at the inventory situation a little differently or maybe help my own understanding. Your inventory balance in calendar Q4 increased, you know, high single-digits and by our math, you are sort of like 98 inventory days, which is like, you know, maybe 15 or so above what you historically carry. So I suppose my question here is, number one, why did inventory grow up in calendar Q4 and how is that not helping you mitigate the issue in Q1 a little bit better?

00:49:09 Uli Dopfer

So inventory in Q4 went up for multiple reasons. One reason was the Brexit. So, also here, we, due to the uncertainty, we decided to increase inventory levels for the UK. Second one is, and in early this year you have always the Chinese New Year where we traditionally increase inventory levels to bridge that period during the Chinese New Year. And then we have, again, we saw a strong order flow in Q4 already, or bookings and we wanted to be ready to ship these orders and that is why essentially, we purchase inventory to fulfill the customer demand in Q1.

00:49:52 Brian Protiva

And we shipped quite a bit in January.

00:49:54 Uli Dopfer

We did already ship a lot in January.

00:49:58 Brian Protiva

So it is helping to mitigate some. We just don't know how, again, it's ... the problems that is, how big is it for us? It is just such a moving target. You guys, you can sit there now and say, ooh, that is you know, they should have better grasp, because if Apple, with their thousands of people, give us guidance in end of January and take it back three weeks later, you can imagine there are a lot of moving parts. It is complex because of one little part in the supply chain, what it means to somebody as a supplier to us, it is really challenging for us. But again, I think we will get it under control. We have lots of people working it. We are looking at analyzing all the different pieces. We are looking at where the problem sets are. How do we address it? Where do we source the products differently? You know, we are dual source. With most things we are dual source. But even there, churning up demand when everybody is going after the same demand is also not as easy. It's a complex situation. So there is just a lot going on. I think you guys have to trust us. We are going to get our hands around it. We have had multiple challenges like this, in fact, even last year, that we managed pretty well. I trust our team. It is an excellent team. And we have strong internationally, globally scaled EMS partners, which would allow us to move as well with the strategy of, re-adjusting and moving dependencies away from regional dependencies that we have right now in some areas. I know it is a hard one for you guys because we can't give you more data, but we are going to do our best. And like I said, the strong Q4 moving into this year, where we look fine. Demand is there. Positioning is there. Great new products. All the things that we showed, we showed that we could grow in the year organically, nicely, should continue down this path as long as this issue is solved. And my tracking of it, we get really good data, is that it is getting better already and that the Chinese government is doing the right things in order to contain this very quickly.

00:52:11 John Lopez (+ Federate News)

Helpful. Sorry. I have two quick follow ups on that if you don't mind. The first one is just related to share, but how comfortable are you that this isn't shifting share to competitors over the, say, the first half of the calendar year? And then just sort of resident in your annual guidance, is your assumption here that whatever you are not able to get done in the first quarter does come back? Or is your assumption that you have some headwind that you carry through the balance of the calendar year?

00:52:47 Brian Protiva

So, I think, we are saying 5% growth and 5% pro forma EBIT. So maybe, you know, some headwind because we just don't know. Mean you could just make the assessment, hey, we're growing at that, let's keep that rate, that's how we forecast, let's go, go, go. So, you know, there's some analysis of numbers and whatever else. So it is not a situation where to say, hey, this happens and then we turn around and we solve it within a few weeks. That is not what we are thinking. We are thinking, hey, we have got these challenges. We still don't know how it is going to be solved, by what time. Therefore, we have to put into perspective, from a global perspective, like I said, our ability to recover, we think is pretty good. And then, shift to competitors? Sure, I mean is there a worry there? I don't think there is any short-term worry. To qualify products in our space takes months. The complexity of integrating into OSSs and management platforms takes half a year. These are not things that shift shortly. So we are very, very close to our customer base. Looking at that, can we miss a new opportunity? Be it if someone wants, you know, has a new opportunity, wants orders right away and we are not able to deliver that product again, it is not affecting all of our products, it is only affecting certain selected products. And therefore, there is going to be a lot of stuff that we still ship. This is not a black or white scenario in any way or form, but, yes, it could impact us. I can't sit here today and say it is not going to impact us. If you look at odds and likelihoods, et cetera. You know, we don't see any tendency at all from our customers to say, oh, we have got to do something else now, if there is any risk and again, we do believe that, you know, most players are going to be exposed in some way or form throughout the next weeks.

00:54:44 John Lopez (+ Federate News)

Catch it. Very helpful, thanks. Thanks for the thoughts.

00:54:59 Lars Friedrich (Der Aktionär)

Hi. Thanks for taking my question. It is a more general one. Bad news just keeps coming. We were talking about strong US dollar, then it was Brexit, a trade war and now it's a virus. And even moving production lines doesn't really seem to help that much. Do you think that it is just bad luck during last quarters or is there kind of special weakness, vulnerability, exposure, whatever you want to call it in ADVA and its business which you shareholders will always have to deal with? Because it's maybe just the nature of the business.

00:55:37 Brian Protiva

Well, I guess I'd have to ask you that question, do you believe that trade wars and corona viruses are not pretty, let's say, surprising and not very standard events? I would tend to say they are very once in a lifetime, or once in a decade or, you know, once in a presidency or something. Could we have a world that is moving to a more chaotic standard and having these issues come up regularly? Sure. But that is going to impact the world. We grew 10% last year. We had two major problems and we grew 10% last year. I would say we adjusted very well, so I will make the statement that I think, if the global world is moving to chaos, is what you're inferring to, it is always going to be surprising events, because these events are pretty one offs. I think ADVA is going to do extremely well there. We are incredibly fast. We have dedicated people. We understand our business really well. That will help us compared to competitors. Will that continue to happen? I am going to tell you, my belief is no. I have been in the business now for, what, twenty-five years and I have had years where there are surprises and then we have had stability over a number of years. We are in a mode right now where there are more surprises than stability. But again, let's put that in context. We grew 10% last year. And, yes, we didn't hit the profitability that we had wanted to, but we hit it in the range that we had guided for the year. So, let's put it in perspective. And what we are telling you this year is we're growing 5% and we are going to be profitable 5%. We were pretty close to last year, overachieved in one area, slightly under-achieved, if you were to say mid of our guidance, I would give us the benefit of the doubt that we, more than most companies, are going to be able to handle the situation. So I guess we can look at it, the glass is half full or that glass is half empty. I am going to go for the half full because I do believe that we as a company are incredibly fast and adjusting to surprises.

00:57:50 Lars Friedrich (Der Aktionär)

Thanks very much, Brian.

00:58:02 Paul de Fromment (Kepler Cheuvreux)

Hi. Two very quick questions for me. The first one is, will the current situation in China affect equally all your divisions. I mean, will cloud access, for example, suffer as much as optical transports from other delays? And the second question is, can you give us some feedback on the ramp up of FSP 3000 TeraFlex, especially regarding your ICP customers? Thank you.

00:58:41 Brian Protiva

Wait one second, please.

So we were just trying to make sure that we understood the question set equally. So, I think more from a finished goods perspective, maybe the Cloud Access piece is a little bit more impacted from a supply chain components and module area. The optical space is impacted. And from a, sync & timing, also from a more from a product side, it's impacted. Hard question to me answer today. I am going to take a rain check on that. We are analyzing those things and putting that together. We have a lot of data. I just, I honestly don't have that at my fingertips right now. It does impact, though, each of our business units. And I said in that 10 to 20 million, there is going to be impact and all three of those business units. Then going forward, ICPs and I mean, that is one of our target areas, both for open line systems and for the TeraFlex product range. We are working feverishly hard to win business in that ICP space and hope to win some of the projects that we are working on to drive volumes. I think that there has been somewhat of a lockdown down on big decisions in the industry due to competitors pushing 800 gig, but they are still going through the process. And as the 800-gig stuff, it looks to be pushed off, at least that is what we are getting back from customer discussions that we are having. You know, that hopefully helps our positioning in competing for those next gen decisions. So, again, back to the TeraFlex, you know, we expect to continue evolve that and it is moving into other customers, but the big wins that fundamentally our transform our business are in the ICP space. But as we said last year, our 10% growth model was not based on ICP wins and big TeraFlex. The 5% model this year is not based on big wins and TeraFlex. Those are breakout scenarios where we go get ourselves double digit millions with one of the large ICPs because others are struggling or because our product is the best or because we can deliver in a timely fashion, et cetera, et cetera. All of which is to be defined. I can't comment on that just now, but I do believe, again, we have a very competitive product.

01:01:13 Paul de Fromment (Kepler Cheuvreux)

Okay, Thank you very much.

01:01:25 Robert Sanders (Deutsche Bank)

Yes, just a few questions. If Europe went with a cap on Huawei of 50%, is there an opportunity for you or do you not really compete with them directly, especially in your portfolio? Second question was, are you ramping up Inphy, in DSPs? There has been a lot of uncertainty around the Cisco/Acacia deal and whether it is going to close or get blocked. I was just wondering if you are sort of risk mitigating on that. Third question was, which components you actually specifically seeing shortages of? Is it like generic stuff, like passive components? You mentioned optical specific components. Is it like lasers? What? Just a bit more detail would be great. Thank you.

01:02:07 Brian Protiva

Part one Huawei. I mean, the limitation right now is trending toward the mobile core discussion. And clearly we are not in the mobile core. In general, though, because of that, people are looking more and more open. You know, how do we get less dependencies on one vendor? Because a lot of these companies were very dependent on Huawei. So, the concept of changing the model definitely opens up the market. Point one. But we are not right there in that first initiation of making decisions because we are not core players. Having said that, it opens up ability in the backhaul and fronthaul areas and we are positioned well in a couple of the Tier 1 accounts in Europe. And we hope to leverage that. But it is not an immediate change, but we see 5G is very interesting. We have won a lot of sync & timing opportunities there and leveraging those two initiatives sync & timing wins, plus Huawei transformational change allowing for business for us going forward. Second, just add onto that, you know, I think the US government at least isn’t pushing as hard on the European governments for transport exclusion. It is a first, it is a 5G discussion. But, you know, that is tending to have those types of discussions as well. But it is not the same political environment. Point two, from a passives and components and lasers. Yes, it is passives. It is some active components, some of the real cheap stuff, you know, that people just got out of. And it is pretty much … some of the stuff is centered in Wuhan, and so it is affecting our pipelines there. It is some builds. We have some of our EMS guys in factories there, building certain parts of our product solutions base. So it is mostly really optical components and some assemblies that are impacted in the Wuhan area, where in the Shenzhen area, it is mostly box builds, Carrier Ethernet and sync and timing. And again there, we are starting to already build products and get those out the door as we speak. So that is coming back online. So it is more that risk mitigation around the optical side. And the third one was Inphy risk management on the DSP piece and that is yes, we told you last time, we had already moved before that announcement was ever made to get balance. We have, you know, we are moving to always trying to pull, you know, two or three suppliers into each segment. So that has been a process that has been in play for two and a half years, probably already now. We have some opportunities already with other, let's say, DSP designs. And going forward, we have a number of projects that allow us to be a lot less dependent on any one provider. What we are being told by Cisco and going to be committed in writing as we want, essentially, they are going to stay an open supplier of components. That is absolutely in their cookbooks in the future. You saw that with the one silicon. So even the new stuff that is coming out for their router-based stuff. They are opening up and saying we are open for business. So they are moving down that pipeline because that is how they are approaching the ICPs and some of their other customers, as piece-part selling. So I think that is not going to change if it does get closed. They can be one of one or two or three suppliers. And if it doesn't get closed, then it is business as usual with Acacia. I am … probably better for the industry, it doesn't get closed. If it does get closed, though, Cisco is staying committed to that. It is fine. And, you know, I think it is not really going to change much of the Acacia strategy at all for the next two, three, probably even four years, for us, as a company. So I don't see that as the biggest risk. The biggest risks for us right now are this, now, the supply chain challenges, this trade war challenges, roadmaps, getting products out the door, etc.. You know, staying competitive and differentiated, innovative are more important probably to us on a level of risk management than the DSP issue.

01:06:36 Robert Sanders (Deutsche Bank)

Great, thanks. Very clear.

01:06:42 Operator

Thank you very much. We have no further questions for the moment. Ladies and gentlemen, thank you for your attendance. I would like to hand back to the speakers for some closing remarks.

01:06:56 Stephan Rettenberger

All right, thank you very much for the interesting debate and active Q&A session. We are closing today's call. Thank you for participation. And we will be back with our Q1 financials in April. Thank you.

01:07:14 Operator

Ladies and gentlemen, this call now has been concluded. You may disconnect.