Transcription

ADVA Optical Networking - Half Year 2020 IFRS Financial

EV00110969 - 68 min

23 July 2020

PRESENTATION

00:02 Operator

Dear ladies and gentlemen, welcome to the conference call of ADVA Optical Networking of the Second Quarter 2020 IFRS Financial Results. This call is being recorded. [Operator instructions] I now hand over to Mr. Stephan Rettenberger, ADVA Optical Networking, Senior Vice-President, Marketing, and Investor Relations. Please go ahead, Sir.

00:40 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 homepage under www.adva.com, in the About Us/Investors section. If you do 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 Investors 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 "believes," "anticipates," and "expects," to describe expected revenues, earnings, anticipated demand for networking solutions, internal estimates and liquidity. These factors are discussed in greater detail in the Risk & Opportunity report section of our annual report 2019. Please also be reminded that we provide consolidated pro forma financial results in this presentation solely as supplemental financial information, to have 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 a substitute for historical information presented in accordance with IFRS. Pro forma operating income or loss is calculated prior to non-cash charges related to the stock compensation programs, amortization, 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 then Uli will talk us through our Q2 2020 financials. Finally, we will have sufficient time for your questions, which we will be happy to answer. Brian, please go ahead with the business update.

02:53 Brian Protiva

Thank you, Stephan. We move to slide 4, please, "Q2 2020 in review." The quarter that just ended was dominated by the global COVID-19 pandemic. The crisis has also left its mark on the telecommunications equipment suppliers. There can be no question that our industry has gained in terms of recognition and importance. Our technologies and services are vital to some of the world's most critical network infrastructures and have played an integral role in helping our global society to move forward during this time of crisis.

After reporting financial losses in the first quarter, our earnings in the second quarter were very positive. Our Q2 revenues reached EUR 145 million, up nicely by 9.3% from the previous quarter and by 8.9% year over year, from EUR 132.2 million in Q2 2019. As we presented in our previous earnings' call, the impact of COVID-19 on the supply chain caused a delay in Q1 order fulfillment. This impact continued in Q2 and increased from approximately EUR 10 million in Q1 to a total of now approximately EUR 15 million. So we were not able to realize the full revenue potential in Q2 and carry a healthy order backlog with us into Q3. Profitability and net debt improved significantly.

The relatively strong revenue contribution from large network operators with comparatively low margins continued. But the cost improvement measures introduced last year made a positive impact and led to substantially higher profitability compared to Q1. From a technology perspective, demand was particularly strong for our optical networking equipment and services, as well as our network synchronization technology. We continue to be very disciplined with our OpEx. In Q2, we saw an addition to the normal quarterly seasonality, a positive impact from our cost reduction programs, which we had implemented in 2019, significantly lower travel expenses, and a weaker US dollar. On the other hand, factors like supply chain challenges and revenue delays increased our costs.

Page 5, an update on demand from our three main customer groups. Let me provide a quick overview on the dynamics of the three main customer groups that are driving our business. Carriers or communication service providers are our largest customer group, typically representing an average of 65%. Add to that internet content providers, ICPs, or companies whose principal business is the creation and dissemination of digital content. Similar to Q1, we continue to see good order entry from the CSPs and the ICPs, which represent normally 10% of our business. Home office, the increased use of e-learning, video conferencing, and streaming services increased the consumption of digital content, and both providers of cloud services and communication services confirm a s significantly higher network utilization. Their revenue contribution to our business is, therefore, trending higher. However, with CSPs in particular, it is being discussed whether the increased demand for bandwidth will also lead to higher revenues and higher CapEx budgets. If the CSPs do not increase their planned investment volumes, we might experience a slowdown in demand from select telcos in the second half of the year.

We're also closely monitoring the development of our business with our third customer group, the large enterprises. This customer group has historically been contributing an average of 25% to our revenues. As expected, we have been seeing some softness in demand from this customer group, and their contribution has been trending lower. In the event of a long-lasting recession, which also affects the Fortune 500 companies, the expansion of these companies' IT infrastructure may be impacted. I want to emphasize, however, that while certain customer groups or regions may be doing better or worse during this pandemic, it is the diversity and the global nature of our customer base that provides resiliency to our business, especially in times of travel restrictions and lockdown, when society becomes increasingly dependent on digital infrastructures.

Page No. 6, "Supply chain update in times of COVID-19." At the beginning of the Covid-19 crisis, we were one of the first companies to point out that Wuhan, China is a center for optoelectronic components and that supply bottlenecks were to be expected due to curfews and plant closings. Since then, the situation has mostly normalized, both in Wuhan and in the rest of China. However, other regions of the world are still struggling with the effects of the pandemic. Every state-ordered lockdown and border closure in countries and regions that are part of our supply chain can cause bottlenecks in the procurement of components, production, transportation and general logistics. Nevertheless, in the past weeks and months we have impressively demonstrated the flexibility and agility in our supply chain. In addition, we took early measures to ensure business continuity in our global development and distribution centers, even under difficult conditions. The safety and health of our employees, partners, and customers have always been our top priority. Around 80% of our employees currently work from their home office. Only activities that require hands-on interaction with our technology, such as system testing and production, take place in our facilities. We continue working closely with our customers, asking them to place orders early, and working hand in hand to prioritize orders and optimize deliveries for mission-critical networks.

Page 7, "Innovation in times of COVID-19." As a telecommunications supplier, our technologies and services are supporting some of the world's most critical network infrastructures. Securing digital connectivity in times of social distancing and working from home has become a top priority. We continue to innovate and are aligned with what our customers need most. With our cloud access solutions, we enable CSPs to deliver software-defined, differentiated, and performance-assured wholesale, mobile backhaul and business services. We saw a slowdown in demand as these technologies are also used by CSPs to serve smaller and medium enterprises. The acceptance of our new-generation 100G aggregator devices, however, has been positive. As I already explained in our last call, many of our customers operate with reduced levels of staff in their labs, so the testing and onboarding of innovative virtual solutions continues to be slow. With our network synchronization solutions, we provide accurate and scalable time and frequency synchronization for mobile network infrastructure, but also for other verticals, such as utilities, media distribution networks, financial services, distributed databases and meteorology. The demand from the CSP community for precise timing, to achieve better spectrum utilization in mobile networks, continues. Our expansion to new verticals looks promising.

As you can see on the lower-right hand side of the slide, we brought new functionality to market, which will further strengthen the competitive edge of our network synchronization portfolio. Especially, the launch of the industry's first ePRC optical cesium atomic clock solution was an important milestone and breakthrough moment in the synchronization community. Last but not least, a few words about our biggest revenue generator, our Cloud Interconnect solutions. This optical networking portfolio delivers scalable bandwidth for access, metro and long-haul networks. We provide high levels of open interworking, programmability and ease-of-use. Per my earlier comments, we have seen steady demand from some of our largest CSP and ICP customers, scaling their network and cloud capacity. The number of TeraFlex customers is now greater than 15 and keeps growing.

With that, let's move to my final slide, page No. 8, "Recent wins and success stories." As I have been preaching to all ADVA employees in the last month, it is imperative that we win new footprint and new customers during the COVID-19 crisis. The risk of the recession has created an extreme focus within our teams to drive growth opportunities and win all projects we are working on. On this slide, we give a few examples of announced customer wins, which will help support growth. In addition, when considering the top 10 new customer projects for 2020, that we as the management board have said are imperative for further growth in 2021, we have already closed on three of these opportunities. Thus, it is my strong conviction that our competitive position has not suffered during the crisis. In fact, I believe that the challenges we have faced with home offices, DevOps, working environment, and the introduction of new enterprise software have made ADVA stronger and relatively more competitive. We are winning all of our competitive bidding situations with the synchronization technology and we are very strong in optical with some work to do in the packet space as we go up the stack and into the larger IP application space step-by-step.

With that, I hand over to Uli for the financial section. Thank you very much.

13:40 Uli Dopfer

Thank you, Brian, and welcome, everybody. As already communicated in the ad hoc release on July 16, revenues in Q2 2020 amounted to EUR 145 million and were up by 8.9% compared to Q2 2019. COVID-19 also impacted our Q2 and a substantial amount of customer orders were unable to be shipped. I will expand on that later in this presentation. The increase in revenues was driven by continued strong demand from major telecommunication service providers and the Internet industry.

Our pro forma gross profit contribution increased to EUR 50.2 million, up from EUR 46.5 million in the year-ago quarter. Our pro forma operating income margin was at 7% of revenues, up from 3.3% in Q2 2019. We are pleased that our cost improvement measures introduced in 2019 achieved the desired effects. And as expected, we incurred lower travel and other expenses due to COVID-19, which also had a positive effect on the margin.

Net income for the quarter was EUR 7.6 million compared to EUR 1.3 million in the year-ago quarter. Thus, we achieved a positive net income for the first half of 2020. Consequently, earnings per share increased from EUR 0.03 to EUR 0.15 year-over-year. Net debt improved from EUR 68.1 million in Q2 2019 to EUR 44.9 million and included IFRS 16 lease liabilities of EUR 30.7 million compared to EUR 36.2 million in Q2 2019.

Next slide, please. Q2 revenues per region. Revenues in all regions developed positively. EMEA revenues increased by 8.2% year-over-year, now representing 53.2% of total revenues. Revenues in the Americas increased by 5% and the region now contributes 37.7% to our global revenues. Asia Pacific revenues increased substantially by 34.2%. The contribution of telecommunication service providers in Asia Pacific was relatively high in the past quarter, resulting in a share of 9.1% of revenues for Q2.

Next slide, please. Quarterly revenue and pro forma profitability. Demand developed well in the second quarter and revenues have reached EUR 145 million, an improvement of 8.9% compared to the year-ago quarter and up by 9.3% from EUR 132.7 million compared to Q1 2020. Despite a stronger demand from carriers and ICP, we experienced a gross margin step-up quarter-over-quarter, resulting from a more favorable product mix. With positive EUR 10.1 million or 7% of revenues, pro forma operating income improved from EUR 4.3 million or 3.3% of revenues in Q2 2019 and also improved significantly when compared to the EUR 1.7 million loss or negative 1.3% in the previous quarter.

We have seen some analyst calculations on how COVID-19 may have impacted our financials for Q2 2020. For the purpose of full transparency, I would like to give some insight into how we calculate a normalized scenario without COVID-19 effects on the next slide.

Q2 revenues were impacted by COVID-19-related supply chain constraints. On the one hand, we converted the customer orders of EUR 10 million shifted from Q1 to Q2 into revenues, but on the other hand, we had to shift EUR 15 million of customer orders into the next quarter. We estimate that our revenues would have been at EUR 150 million in Q2. Shifted revenues from Q2 to Q3 have less favorable customer mix and product mix, resulting in higher gross margin for Q2. For that reason, Q3 margin could be adversely affected by these delayed shipments. COVID-19-related OpEx savings related mainly to lower discretionary spending of about EUR 1.9 million. In total, we estimate a normalized pro forma operating income of EUR 8.8 million or 5.9% of revenues for Q2 without any COVID-19 effects, which is EUR 4.5 million or 2.6% above from the year-ago quarter. It is unclear how the ongoing pandemic will develop within the second half of 2020 and beyond, but it is very likely that it will further impact our business and financials. Realistically, this situation will be just part of the new normal and we will have to decide to what extent we will disclose the COVID-19 impacts going forward.

Turning to the balance sheet. Slide 14, please. Q2 2020 credit metrics remained very strong, with an equity ratio of 48%. Our gross leverage was at 1.1 and improved strongly compared to the 1.4 seen in Q1 2020. This indicates a solid investment-grade profile. Liabilities to banks were EUR 81.8 million and IFRS 16 lease liabilities were EUR 30.7 million and make up our total financial debt of EUR 112.5 million. Year-to-date ROCE was at 2.5%. Our cash position increased significantly from EUR 52.8 million in Q1 2020 to EUR 67.6 million in Q2. This is the result of a strong free cash flow generation of EUR 23.4 million in Q2 2020. Our working capital improved from EUR 134.2 million to EUR 127.9 million and was 22% of revenues in Q2. Furthermore, we greatly strengthened our financial flexibility by concluding a KfW backup facility that could be utilized in the event of a COVID-19-driven crisis scenario.

Turning to our quarterly operating cash flow development, Slide 15. As 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. In Q2, operating cash flow was very strong, with EUR 37.8 million, and improved by 72% year-over-year. This is mainly due to higher earnings and aforementioned working capital improvements.

Next and final slide, please. The telecommunications equipment industry has been less affected by the crisis than many other industries and, as a matter of fact, our Q2 was very strong. We outperformed both the year-ago quarter and the consensus for Q2. For this reason, we preannounced our key numbers within an ad hoc release on July 16. However, due to the remaining uncertainties about the further course of the crisis and its potential impact on ADVA's business, we are currently not in the position to update our yearly guidance for 2020. As a reminder, with our original guidance for the year before the COVID-19 pandemic, we had anticipated revenues to exceed EUR 580 million and to achieve a pro forma operating income above 5% of revenues. Many things have changed in the meantime, but despite the above-mentioned uncertainties, we believe that we will continue to grow also in Q3 2020.

Thank you for your participation. You all be safe. And with that, I hand over to the operator to open the Q&A session.

Q&A

22:56 Operator

Ladies and gentlemen, we are now starting our Q&A session. (Operator Instructions) The first question received is from Simon Scholes of First Berlin Equity Research. Your line is now open. Please go ahead.

22:56 Simon Scholes

Thanks for taking my questions. I've got three of them. You mentioned that there's a debate going on as to whether growing demand for bandwidth will actually translate into growing investment by carriers later on this year. I was wondering if you could enlarge on that slightly.

Secondly, I was wondering if you could comment on the average size of the TeraFlex orders you've received so far.

And thirdly, you were talking about some slow demand for virtual solutions. You mentioned that's due to the fact that you've got fewer people in labs because of COVID. So does that mean that we should expect investment in that area to accelerate once COVID is over?

24:44 Brian Protiva

I'll start. Uli, you follow maybe on the average size of the TeraFlex, but I have an answer there as well.

So, growing demand in bandwidth and if it leads to growing investments. Certain carriers have told us, no, we're not going to invest more than the original budget, yet we've got demand in excess of what we originally thought, but it's project-related. That's not bad for us because we're working in the enterprise access and metro spaces. Even where some of our big customers have said not more spending in the infrastructure, but all of these individual projects that are customer-driven will be supported, ultimately, it's good for us. So that's good news.

If we're in a carrier with pure infrastructure and they're not going to increase their budget by the end of the year – and there are some of those – clearly, if they've over-ordered in the first half, we're going to feel it some in the second half. My sense is, though, that there also a number of CSPs or carriers that are going to overspend. So we've also heard from others that would say, you know what, we're going to power through this because it's important to differentiate and to supply our customers with the needs that they have right now.

And so I'm going to group that together and say we're still cautious. That's why we're telling you we don't know this 100%, but that's why the discussion and why I put it that way specifically. It's because it's looking better and I'm hoping that people realize bandwidth's growing and it's an advantage for them to invest more as a whole. But I can't give you an exact answer presently – too many customers, not all of them telling us what they're going to do, etc. But we have a good feeling for the second half.

Average size of the TeraFlex orders. They're all big, but they're not web-scale. So what we're doing is we're bringing in TeraFlex into DCI, into existing large customers, and we're driving business. And even a small order is big. It goes into the hundreds of thousands and ends into the millions pretty quickly. So, nice-sized orders. I don't have the exact average size.

I don't know if Uli can pull that, but it starts already at a decent size when you have 2 TeraFlex sitting at the end of a direct link.

And the final answer to the slow demand for the virtual solutions is -- I just want to qualify what those are. One is Ensemble Connector, which is the edge cloud opportunity we have on a white box or the operating system and we can host any application sitting out there on one single box in an enterprise site. We also have the disaggregated cell site gateway, TIP program with Facebook, and Telefonica, and Vodafone, etc. And the third one is we have our activator OS, which sits on top of a Broadcom white box for provider edge applications. So really, three areas. All of them are slow than we'd want because they pushed off lab testing. We've lost three, four months. The question was, does it pick up quickly? Well, we hope that they get back on, bringing their lab people, test more quickly and that we're able to pursue those opportunities aggressively. They're not going to really impact this year at this point. So we are slow-rolling forward virtual solution contributions in 2020 and hope to scale that strongly or rapidly in 2021.

28:51 Operator

(Operator Instructions) And the next question is from Mr. Junghans of Commerzbank AG.

29:06 Michael Junghans

Good afternoon. Thanks for taking my questions. I have a couple of them. So, the first question is related to your selling and marketing expenses, what you showed here in Q2. It was down 18% year-over-year. Could you just give us a little bit more color here? What do you expect on your selling and marketing expenses here for the second half of the year? This will be my first question.

29:33 Uli Dopfer

Yes. Michael, I will take this one. So yes, we experienced, as you can see, a large drop from Q1 into Q2 in selling and marketing. Of course, you know yourself, many events have been canceled like the OFC, like the Mobile World Congress where we usually are very present. Many other marketing events have been canceled, but also, of course, travel. I mean sales usually incurs quite some travel costs. So this completely shut down essentially during the course of Q2. So we assume that our selling and marketing expenses will slightly increase going through Q3 and then maybe going almost – not quite, but almost or close to – normal in Q4.

30:23 Michael Junghans

Okay. For instance, for Q3, you expect a sequential increase in this expense line, right?

30:31 Uli Dopfer

A sequential increase? No, I would not say a sequential. If you look into Q3 of 2019, we were in the EUR 15.4 million-ish range. And I don't see us going back up to this number just yet. So we should be way below that one.

30:52 Michael Junghans

Okay. Then coming to the Slide No. 13 here, maybe you can walk me through the Slide No. 13 again because I have some issues with this slide here on the comments given on the right-hand table here. First, the comment that your revenue in a non-COVID-19 world would have been EUR 150 million in Q2. However, I remember that you had a revenue shift in Q1. So, going from Q1 to Q2, one would have guessed that revenues would have been at around, I would say, EUR 135 million in Q2 here if I adjust for this effect.

And then the second remark that was given here: you said that in a non-COVID-19 world, you would have had a lower gross margin here. I would have guessed that in a non-COVID-19 world, you would have had actually a higher gross margin because I would have guessed that your product mix with the private enterprise would have been higher because more people would still be working non-remotely. And this means that your product mix with the CSP and with the telecoms would have been lower in this past year in this point. So maybe you can tell me where I see the things a little bit more differently than you do.

32:06 Uli Dopfer

Sure. So, first of all, the EUR 150 million. How do we get to the EUR 150 million? It's essentially the EUR 145 million we actually realized in Q2 minus the EUR 10 million that we shifted from Q1 into Q2, plus the EUR 15 million that we had to push out from Q2 into Q3. So this gives you the EUR 150 million

So why is the margin profile different? As you remember, our Q1 margin was fairly low, and this was due to the fact that the EUR 10 million we had to push out from Q1 into Q2 had fairly high margin. You see there's a little bit of an interesting picture here. That's why the margin essentially would have been a little bit lower in Q2, based on the fact that we just had the luck that the orders that have been pushed out from Q1 into Q2 had the higher margin. Does that answer your question?

33:11 Michael Junghans

Yes. Yes, that answered my question. Thank you. My last question would be on your provisions for personnel expenses. I see in the documents, you had book-to-fund in six months around EUR 10 million here so far. Could you tell us, for your present provisions, what is your budget here for the final year? And when will these provisions become cash outflow?

33:37 Uli Dopfer

Usually, what we do is, as you know, we have an internal plan and our employees get paid partially on personal goal achievement and partially on profitability. Usually, we accrue 100% of these bonuses throughout the year unless we really see that we deviate in either direction from our yearly goal. So usually, we pay out these bonuses in Q1 and Q3. As you can see in our cash flow slide, the seasonality – and this is the employee-related costs that I mentioned here--

[34:18 technical difficulties – call dropped]

34:46 Uli Dopfer

All right. I will just start over again. So, we have personal bonuses and company bonuses. ADVA employees get paid based on personal goal achievement as well as company performance. So, we accrue usually 100% of these bonuses throughout the year and we pay them either in Q1 or in Q3 of the year. If you look at our cash flow slide, this is mainly what drives the seasonality of the cash flow is that we pay out these bonuses twice a year. Did this answer your question?

35:30 Michael Junghans

Yes. You've answered for the questions so far, yes. It's good to know this.

My last question would probably be, I'm not too sure if you're a little bit too cautious here with regards to the growth potential, what you could achieve here. I understand that there's a debate in this moment going on whether the carriers would have pulled forward demand to extend the bandwidth forward into the first half of the year. However, looking at your growth that you've achieved so far in six months' time, around 6% to 7% growth year-over-year and you cannot so far give us a guidance at the moment for the year. On the one hand, you see a slowdown in demand. It is what you write in the documents. And on the other hand, you expect a quite solid [inaudible] for Q3. So, I want to know which kind of direction now I should take because, actually, I would say you can probably achieve the original scenario, what you originally guided for, around [number inaudible] in sales, whereas I would probably guess that you would not reach the gross margin or the pro forma EBIT margin, that you originally targeted for.

So maybe to put a little bit more color here about why you cannot give us a straightforward answer. Because actually, this would imply that you would have had to experience significant shortfall in demand in Q4, right? So a little bit to know why you cannot just say, okay, we can, for instance, achieve this net growth figure for the second half of the year. This would be helpful.

37:20 Brian Protiva

So, I guess, high level. What we said is we feel very comfortable to grow in Q3 again. We said, though, we have no guidance because the range would be very, very large in Q4. We've got to book orders in Q3 and partly in Q4 to fill the pipeline for Q4. And because the Great Recession is hitting us in various different countries, we're conservative. We're feeling better, but we're conservative and we really have to see those orders flow because we don't want to be guiding you down a path that says this is what we're going to do, and then not deliver on it. I think our goal is to deliver on what we're committing. We're committing quarter-for-quarter. And yes, Q4 is open We can't really say more. We could give you a EUR 20 million or EUR 30 million range maybe. That doesn't help you either. I think the issue is we'll know more as this quarter progresses.

We feel comfortable with the business. We're winning new customer opportunities. We're moving along effectively in the work-from-home concept. We haven't lost much efficiency. So there are many good things, but there's a lot of questions out there on the market. And we try to balance that by letting you know what those questions were. Enterprises, yes, recessionary tendency to then reduce budgets also in the running year. CSPs, if they overspent in the first half, do they then balance that in the second half? Again, what we said is a number of them are saying customer-specific projects still moving forward, excellent. We're having some of them saying, you know what, I have to invest anyway. I'm going over.

And now we have some that are saying, I don't have the budget, I can't invest. And now how that plays out is a very complex model.

So I didn't help you at all, but I just want to reiterate, it is difficult times. And therefore, I think your question is valid, very valid, good question, yet we have to stick to our guns and say we're not forecasting or guiding for 2020.

39:44 Uli Dopfer

As I said, we still also have uncertainty in terms of the supply chain or the challenges with the supply chain. This won't go away anytime soon also. So you don't only have the question mark regarding the demand. You also have the supply chain issue, and they are really tough to judge.

40:06 Operator

The next question received is from Johannes Ries of Apus Capital. Your line is now open. Please go ahead.

40:13 Johannes Ries

Good afternoon. Maybe some short follow-on questions. First, you said the order backlog is good. Can you tell us maybe how good it is? Maybe is it higher than last year even? How much order backlog covers a quarter? I think it's more only for Q3, if I got it right. Only to have a feeling about the short-term visibility you have.

40:44 Brian Protiva

Uli, I'll start, maybe you follow. Order backlog is good. It's better than last year. It's been solid for a number of quarters now because we had very strong bookings in Q4, very strong bookings in Q1, and evolving bookings or steady bookings in Q2. So that has helped us build a very strong backlog. The percentage of a normal quarter going in is usually a 50%-50% kind of thing. We are above that, but we don't give that transparency each and every quarter. So I'd like to say our order backlog is good for Q3 or we have some order backlog already for Q4, but we need to book orders clearly in Q3 to fill end of Q3 and into Q4 numbers. So, it's solid, but we can't give more transparency than that.

41:45 Johannes Ries

Maybe another question regarding the mix. You said you had a positive product mix partly because of products which moved from Q1 to Q2. But how has the software and service part of your business developed? The virtualization, which had been a driver, we expect is maybe pushed out to next year, but how did it develop? And do you still think in the foreseeable future to achieve the target of 20%, say?

42:20 Brian Protiva

We've exceeded 20%. Services is strong. Software is steady. So we had good software growth last year, but it's now steady. And that's part of the reason that the virtualization strategy hasn't yielded results yet. But we're in the 7% to 8% range in software and we're in the 13%, 14% range in services, in that kind of a range. It does move at a CEO level kind of frame, but we have exceeded the 20%. And now I'm starting to look at, do I start driving for 25% for software and services? I think fundamentally, probably in 2021, that will be the next goal-setting done, to continue to increase that. And we do have the potential to do that.

43:12 Johannes Ries

Super. Another question on the ISP business. Maybe you have a new cloud connect product out and you hope maybe to win back some shares at the ISPs. Has the case been part of your success in the second quarter here? Or how is maybe your proceeds at the ISP with your products?

43:44 Brian Protiva

I think an ISP represents a huge opportunity for an ADVA. You would see that in our numbers much differently if we were to have a massive win. We continue to win little projects here and there. We are in discussion with four of the five big ICPs on various projects. We have some very interesting products and we continue to evolve that story. Yes, it's trending up, but it's not a steppingstone right now. There's no opportunity to drive, all of a sudden, a massive amount of upside in revenues. But again, all of our planning has never included that. So, our growth last year didn't include that. Our growth forecast this year at the beginning hadn't included that. That's not part of our model, but we are working on that and we hope to be successful step-by-step. The world is changing. New models are coming. And I think ADVA has some cool competitive products to be able to address those opportunities.

Some of the opportunities though, with the new network architecture, drives less spend, let's say, in muxponders and transponders and more to optical modules, as an example. So there's a lot of moving parts. Important target market for us, 10%. And it's been, as we made clear in our presentation, an area of strength during COVID-19.

45:18 Johannes Ries

So, there's opportunities going forward, but hard to predict and hard to, I guess, to guide on?

45:26 Brian Protiva

Exactly. They're very fast-moving, very technically driven, very fast-moving. They are very strategic, lots of moving parts. And there's all sorts of parts to that equation. And again, we do business with three of them regularly. A fourth one, a little bit here and a little bit there. And we're working on more with all of them.

45:52 Johannes Ries

Okay, okay. Another question on your enterprise business. A lot of enterprises have also moved to home offices. So, I was a little bit surprised that you didn't saw, I guess, a positive development. And even – from what you are saying – that you maybe reviewed and delayed investments in the IT environment surprised me a little bit. So, therefore, are you not benefiting if the people maybe move to the home office? Some others like Bechtel had a really booming business because they sold a lot of equipment. But you saw it more at CSPs and then under private. And I'm a little bit surprised that you have so many banks in your private enterprise. And therefore, is that a disadvantage going forward, that maybe banks could also come under more pressure? So far, how do you see the enterprise maybe in a two years' view?

46:49 Brian Protiva

First of all, small and medium-sized enterprises definitely suffered. Large enterprises, definitely in normal connectivity, they actually started to spend more money. And so the CSPs, the carriers that sell that to them, they suffered in the small and medium-sized, but actually had some benefit on the big guys. That's why they had some customer-specific projects that we're benefiting from. Yet, we sell into the DCI space. And there were some large enterprises that actually had to restrict spending. So our biggest application in those big enterprises is DCI connectivity. And that doesn't benefit that much from, let's say, home office, but growing bandwidth, yes. Over time, they'll spend there as well and it helps us.

So my view is I think enterprise as a whole, small and medium-sized suffered some; big enterprise, they actually spent more in some connectivity areas, but not necessarily in some of the areas that we work with them on, their longer-term IT infrastructure projects. I see enterprise being strong over the next two years because they've all understood that it's all about IT and it's all about the right software and information at your fingertips and the ability to move people at will, mobility and all the things that we can enable by investing in the right IT infrastructure. So whether you go cloud, whether you build out your DCI infrastructure, those are things that we can benefit from. And therefore, I feel positive in the two-year area.

In the short term, we're still looking and trying to understand, how does it balance out? Again, many moving data points. So far, so good if you look at the big picture, but we're trying to be as transparent as possible in helping you to map where our strengths and weaknesses are.

48:41 Johannes Ries

Very clear, but we're now also in the midterm at least of the push to digitalization. Maybe on your own business, two points. I just ended a call with [Philips?] just before. And they said, like many companies told me in the last weeks, we will partly stay with home offices and we will not travel as much as we have done before. We have done a lot on the virtual side. Therefore, part of your cost savings maybe you have seen during the crisis, could they stay for a longer term and you maybe need less office space and things like this, that other companies told me, too?

49:19 Brian Protiva

Well, definitely savings in travel. Definitely. In facilities, we're looking at that very closely. Our view is we're now going out to all our people and asking them very personal questions about work-from-home and efficiency and stuff. We've looked at lines of code and bugs. We're really good. But if you don't have people in the room driving whiteboard discussions, innovation discussions, going to lunch afterwards and the a-ha factor in a conversation… the three of them after that, they come up with that innovative spark or idea. You lose that. And therefore, we're not at the point where we're saying, you know what, everyone work from home, whatever. We are an innovation company. We need radically good, intelligent people with good ideas, and we want to make the environment most efficient for that. Therefore, I think some of these companies are making mistakes by going down the path, oh, look, productivity is just as good now for three months. Sure, people aren't burned out. They put their headphones on, don't listen to their kids or their wives or their husbands or whatever else and they make it work. But longer term, we have to look at reality of that.

The second thing is we're benefiting from relationships we've built over 10, 20 years. And ADVA has long-term employees. That means we can benefit a lot from customer relationships and personal relationships within ADVA, managers' relationships. Those need to be personal. So again, there we're not all going wild and saying we're going to cut half our facilities costs. What we say right now, yes, we will lower costs. I'll commit to that because I think we can do less internal travel. We can manage our travel expenses effectively and save millions. And in facilities, we might come back with a saving millions policy as well, but there are reasons for people working together. And remember, after 9/11, how nobody traveled for some period of time and then a year later or two years later, it went back pretty quickly. There are advantages for the competitor that's sitting across the table from the customer to win that next phase of the business versus the person who's sitting at home with his books being shown live in the background. There is a difference.

So long answer, we're looking at it closely. We're going to optimize it. We're going to drive change in ADVA, but we're going to do it intelligently with all the data and all the feedback from our employees, customers, suppliers, et cetera.

51:48 Johannes Ries

A last question more in the direction of Uli. Maybe more analysts are expecting a further weak dollar, et cetera. Maybe this could be a trend. Is this a positive for you? I think you still buy more in dollars and your sales are in dollars. Is that right? Say, so a weak dollar would be good for you or is it wrong, what I see?

52:13 Uli Dopfer

No, this is still correct. We buy about 90% of our components in U.S. dollar and our purchasing volumes still exceeds the revenues in U.S. dollar. So yes, a weak U.S. dollar will definitely benefit us. Remember last year, we got hit by the strong U.S. dollar. And this year, hopefully… we will see. We should benefit from it, in any case.

52:44 Operator

The next question received is from Tim Savageaux of Northland Capital Markets.

52:55 Tim Savageaux

I'm glad I was able to make it on. A couple of questions. One on the kind of market and competitive environment and one more on the numbers.

First, Brian, I was interested in your comments about new opportunities being less oriented around transponders and muxes and more on optical modules. I assume that's a reference to 400 ZR and cloud guys, in particular, maybe looking to adopt that sooner rather than later. I wonder if I could confirm that and maybe get you to expand on pluggables and general, coherent pluggables in the cloud, and how you see that developing?

And then semi-related to that, what you're seeing in terms of competition for the TeraFlex from 800-gig technologies? We've seen a couple of relatively high-profile trial announcements recently, probably more in the carrier space. So that second part of the question, I'd ask you to expand your commentary beyond cloud into carrier with regard to what you're seeing competitively from 800-gig solutions. And I have a follow-up.

54:09 Brian Protiva

So the first one, I mentioned the pluggables. It's not because people are going full board into that, but it's because it's part of the look at architectural change and how they're going to drive networks. And yes, I think the bigger you are, the more likely you could do that kind of a networking infrastructure and manage it all effectively. And in smaller guys, it makes less sense. They want one throat to choke, et cetera.

So first of all, that's going to play a role, but what I was saying was the complexity of the decisions and the timing it's taking to make bigger decisions out there and the evolving network. So clearly, we understand that you could have a proprietary end-to-end solution. You could have an OLS with a transponder shelf, a muxponder shelf or you could have an OLS with pluggables or some combination of there. And so as people go down the path and making decisions, a lot is in flux. Different people are making different decisions. And Tim, I don't want to lead you down the path of one or the other. I think there's a healthy mix of optionality there and people are going to make the decisions based on architectural cost, ease of installation, service infrastructure, how their DCI infrastructure is set up, all sorts of things. I can't answer that question easily straight out to you, but it's one of a few different solutions. I don't see the market shifting heavily, dramatically and quickly. So I do also see it as an enabler for an ADVA in certain application spaces.

Second one is the TeraFlex. We have our own 800-gig solution. So we've got and have 600-gig for, what, a better part of a year now? 800-gig, we are now starting to offer and we will even have single channel 800-gig, 140-gigabaud solutions coming down the pipeline, most likely by Q2 of next year. Again, I told you last time, there's a lot of marketing out there, but there's a lot more to it, a lot more complexity in these decision-makings. And there are a lot of other things that are actually as important as the decision, 400, 600, 800 subcarriers, single channel, dual channel, or super channels… it's a little bit more complex than that. So I'll summarize. We do not see that impacting our business at all. We see us actually being able to one up them very quickly, and from a technology perspective, and be very competitive with the solutions out there. And I think it's not fundamentally changing the game like many years ago where Ciena was out there a year ahead in that step-up. And their step-up, that's not there anymore. So there'll be a lot of people that are competing and are going to be competing on a lot of things besides the bandwidth war or the marketing war on 400, 600, 800, 1.2-terabit. I hope that was the answer that you were looking for.

57:29 Tim Savageaux

I'm not looking for anything in particular, just your perspective, and that was very helpful.

Back onto the numbers. I just want to clarify, I guess, Uli commented and then you followed up about expectations for growth. It sounds like that comment was about Q3. I'm not sure if that's sequential or year-on-year, but actually, the compares are about the same, but any further color on that would be appreciated.

And then kind of along what that, looking at the Q2 results, in particular, it seems like you had some particular strength in Europe. It seems like these carrier dynamics that are on increased traffic are worldwide, but is there anything in particular happening in Europe outside of the fact that a lot of your installed base is there that's driving strength?

58:40 Uli Dopfer

As you said, Tim, it's sequentially and previous year is pretty much the same. So yes, we anticipate we will grow year-over-year and sequentially, how much has to be seen. Again, it all depends on how sustainable the supply chain will be and if we'll be able to close some of these orders that Brian was talking about, but we are confident that we would grow.

59:14 Brian Protiva

From a European perspective, yes, we see Europe has been doing well for us. So, expect some growth there, but in general, if you look at order flows, Europe's doing well for us. Back a few months ago, people were saying it's U.S. and big orders coming from large carriers out of the U.S. I think our experience has been that Europe has been very steady as it goes throughout the pandemic. So feel comfortable and confident that Europe can continue moving forward. And I don't know if it's our competitive edge or if there is competitive shifts going on or Europeanized decision-making or what the reason is, but we feel comfortable with Europe, I should say.

01:00:03 Tim Savageaux

Okay. If I can just squeeze one more in quickly, just on the gross margin side. And you mentioned this, but overall, with enterprise being weaker and your optical business being stronger, you kind of would expect pressure on gross margins there. Instead, you saw a mix driven strength. I wonder if you can give us any more details maybe within the carrier business. Should we assume that's just more maybe capacity, line cards, less chassis that's driving that within optical? Or what might be the dynamics that drove the strength in gross margins in Q2? And that's it for me.

01:00:45 Brian Protiva

So that's high level. I think we tried to mention some of the gross margins. I mean, the weaker dollar helps us, right? It hurts our revenue dollars, but it definitely helps our ability to drive gross margin and also it can support profitability slightly. Remember, it's almost like self-hedged, but from a gross margin perspective, you are buying in dollars and selling heavily in other currencies. It can help you when the dollar is weakening as it is. So I think there's that one trend.

Then there's product mix that we talked about. Some good stuff coming in from Q1 into Q2, which was good product mix helped our margin composition. From a customer mix, that was more pressure on the margins than support. But I think, high level, Q1 was just extraordinary bad. A lot of bad things came together to give us very low margins. Q2 is more normalized. Moving to Q3, we have the telco exposure and there's less gross margin in some of those large accounts, point one, but we have the issue around the dollar that's helping us some. So that should compensate some for that. We also have good cost reduction programs this year on certain pieces that we designed and innovation.

So I think there's a number of moving parts. Tendency would be probably slightly lower moving into Q3, but we're working on that as we speak. So let's see how that dollar rate impacts us and some of the planning and cost reductions impact us. But what I will say is I wouldn't expect increased margins. I would expect slightly lower margins if we're really supplemented by dollar. In some other areas, maybe we can be flattish as we grow into Q3. That would be my gut feeling. Uli, would you agree with that?

01:02:53 Uli Dopfer

I would agree with that. And probably one thing that will also help us in Q3 is we saw a lot of increased freight cost in Q1 and also early Q2, and this seems to have eased out a little bit. I guess, in Q1 and beginning of Q2, we felt freight costs up to 4x higher than usual. And now we are going back to normal. So this will definitely also help our gross margin on top of what Brian just said.

But again, I would not assume that our gross margins will increase. Flattish or slightly down is probably more realistic. And again, if you remember what I said about the EUR 15 million orders that shifted from Q2 to Q3, this is also a rather lower-margin business. So this will also have an impact.

01:03:49 Operator

And the next question received is from Paul de Froment of Keppler Cheuvreux.

01:03:58 Paul de Froment

Hi. Thank you for taking my questions. I know that you've partially already answered that, but my question was on the cloud access segment. Could you give us your view on the evolution of the cloud access segment in this crisis? Could it be possible to see an improvement of this segment despite COVID-19? And finally, what's your feedback coming from large companies regarding their orders in H2? Could they improve?

01:04:37 Brian Protiva

So the first one's answer is the large customer issues. As indicated from the large carriers, it's mixed. It's harder to get information from the large enterprises because usually it's a small part of their spending. And it's just not as sophisticated, not as focused on that spend relative to their bigger spend. So our general information would be enterprises, we hope that there's not too much of a slowdown as indicated and it comes back strong into next year, and the carrier is a bunch of moving parts.

And on the edge cloud, the access piece coming back, we've introduced a number of new products, aggregation products and virtualization-based products. So we've introduced a lot of products. So yes, that stuff can come back if we're able to win footprint with our new products. And as the labs open back up, we're able to compete for new footprint and hopefully win new footprint. And therefore, we can grow.

I think from a competitive landscape, we're doing well. We have some really interesting products, but we've got to implement and win the business. So it's too early to tell you that we're going to turn that around, that access piece and grow it in the second half or even the beginning of next year, but we're fighting with very many new interesting products with a number of new footprint opportunities.

01:06:27 Brian Protiva

I think we've exceeded the one hour. So just last question, if there's anything out there.

01:06:38 Operator

We've received no further questions, so I hand back to you.

01:06:43 Brian Protiva

I'd like to thank everybody for taking the time. Clearly, interesting times for all of us, and I think we've all adapted to the change fairly successfully. Knock on wood, I hope you all stay healthy, as Uli has already said. And we're doing everything we can to protect anybody who is associated with ADVA. At the same time, we're running a business, which is critical, and I think our people are totally onboard with that. Be safe, focus on business, continue to evolve ADVA. I think there's a lot of motivation and a lot of opportunity for us out there. We will go and make it happen. Thank you very much.