ADVA Optical SE

Q3 2020 Earnings Call

Question & Answer Segment

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Transcript

Speakers:

Brian Protiva

Ulrich Dopfer

Ladies and gentlemen, thank you for standing by. I am Hailey, your Chorus Call operator. Welcome and thank you for joining the ADVA Third Quarter 2020 IFRS Financial Results Conference Call. During today's recorded presentation all participants will be in a listen only mode. The presentation will be followed by a question-and-answer session.

I will hand the conference over to Mr. Stephan Rettenberger, Senior Vice President of Marketing and Investor Relations.

Please go ahead.

Presentation

Stephan Rettenberger, Senior Vice President of Marketing and Investor Relations.

Yes. Thank you Hailey 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. Should you not have the presentation in front of you, you may want to access it on the conference calls page in the Financial Results section of the Investors section on that website.

Before we will lead you through the presentation, as always, please be informed this presentation contains forward-looking statements with words such as believes, anticipates, and expects to describe expected revenues and earnings, anticipated demand for networking solutions, internal estimates and liquidity. These factors are discussed in greater detail in the risk and opportunity report section of our annual reports 2019. Please also be reminded that we provide consolidated pro forma financial results in this presentation solely as supplemental financial information to help the financial community make meaningful comparisons of our operating results from one financial period to another. This pro forma information is not prepared in accordance with IFRS and should not be considered a substitute for historical information presented in accordance with IFRS. Pro forma operating income and loss is calculated prior to non-cash charges related to the stock compensation programs and amortization and impairment of goodwill and acquisition-related intangible assets. Non-recurring expenses related to restructuring measures are not included. Unless stated otherwise, all numbers are presented in euro.

We will target to limit this conference call to 60 minutes. As usual, Brian will start and provide a business update and outlook, then Ulrich will walk us through our Q3 2020 financials, and finally, we will have sufficient time for your questions which, we'll be happy to answer.

Brian, please go ahead with the business update.

Brian Protiva, CEO

Thank you Stephan. Moving to Page 4 Q3 2020 in review. Q3 was the third sequential quarter to be significantly influenced by the global COVID-19 pandemic. The latest news of a second wave with infection rates again increasing in many countries is worrying, following the relaxation of preventative measures over the summer months, there is now the threat of renewed tightening of a lockdown regulations with disruption to people's lives and business operational processes in many places. While many industries are now struggling for economic survival, the topic of information and communications technology ICT is increasingly becoming the focus of political discussion. The current crisis shows how important and efficient and robust telecommunications infrastructure is for the functioning of an increasingly digitized economy. After reporting a very strong Q2 our positive

financial performance continues. Our Q3 revenues were up one 1.1% sequentially and 1.6% year-on-year, reaching EUR146.7 million. Profitability and net debt improved further with our pro forma operating income up by 49.5%, reaching EUR11.1 million or 7.5% of revenues. Our customer mix is still biased towards communication service providers or CSPs and Internet content providers, we call them ICPs, responding to the bandwidth demand driven by work from home, video conferencing and the use of cloud services. Demand for our products and services has been pleasingly robust in the first 9 months of the fiscal year to-date, although a bit slower in the past quarter. The third quarter is always subject to influences of the vacation season with a slowdown in business activity in July and August. However, there were no exceptional swings in the year-on-year comparison. Our optical networking portfolio providing additional bandwidth for fiber optic networks and our network synchronization technologies delivering precise timing won most competitive bidding opportunities due to technology differentiation. We continue to be very strict and disciplined with respect to our OpEx, as committed to in the middle of last year. The positive impact from our cost reduction programs implemented in 2019 continues, significantly lower travel expenses and a weaker US dollar, help us further offset some of the OpEx surprises we have faced due to the COVID-19 crisis. In addition, we still see some supply chain challenges compared to pre-COVID-19 times.

Slide 5, regional revenue developments in times of COVID-19. In the last quarter, we spent a good amount of time discussing the spending behavior of our three customer groups. Today, I want to focus a bit more on the regional trends; order entry from our largest customer group, communication service providers, continues to be satisfactory. This is especially true for Europe where network expansion has traditionally been strongly geared to current demand, thus further investments and upgrades are being made to adequately support the new data streams from home office, video conferencing and streaming services while at the same time they are laying the foundation for 5G. EMEA revenues increased by 2.0% year-over-year now representing 54.1% of total revenues. CSPs in North America, seem to be a bit more cautious in the second half of this financial year supported by some of the forecast from our competitors. The CSPs invested aggressively in the first six months and seem to be slowing down with their capacity expansion. Internet content providers spending was still strong in Q3. Overall, revenues in the Americas decreased by 5.7% on a euro basis. Please note that the decline is a change based driven and the region now contributes 35.8% to global revenues in Q3 2020. Asia-Pacific revenues increased substantially by 36.2% the contribution of our largest communication service provider in the region, continues to be strong after some weakness in 2019, which is driven by regulatory uncertainty. In general and across the APAC region, we showed strength driven from our network synchronization portfolio. Asia-Pacific contributed 10.1% to our total revenues in Q3 2020, and with that let's move to

Page 6: Technology demand in times of COVID-19. In addition to the geographical view, I want to add some color to the performance of our technology tripod. Three legs to stand on gives us balance and strength. 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, the demand development has been influenced by the pandemic. Starting in the upper left hand corner with our cloud access solutions, demand and the upgrade of our product portfolio for this part of our technology tripod was behind our pre COVID-19 expectations. The portfolio enables CSPs to deliver software-defined, differentiated and performance assured wholesale mobile back haul and business services, while the virtual world is striving the real economy is hurting and our customers are seeing a slowdown in demand for Innovative Enterprise services leading to weaker demand for our cloud access solutions. In addition, testing and onboarding of innovative virtual solutions continues to be difficult due to reduced levels of staff and limited access to labs, leading to difficulties with the introduction and operationalization of new technologies. Thus, some projects have been delayed. I still want to highlight that since the beginning of last year, we have won 20 new NFV customers and the acceptance of our new generation 100-gig aggregator devices has been very positive. Going clockwise

to the upper right hand corner of the slide, our biggest revenue generator are 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. From my earlier comments, we have seen steady demand from some of our largest CSP customers especially in Europe and ICPs, scaling their networks for cloud capacity and we have had more TeraFlex wins. Last but not least, our network synchronization portfolio, lower left hand corner of the slide. With these solutions, we provide accurate and scalable frequency and phased 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. The revenue contribution of this business unit is growing much faster than the other two, albeit off a smaller base. Our expansion to new verticals looks promising and the excellent growth rates will continue for years to come. And with that, I'd like to move to my final slide

Page number 7, recent wins and momentum. The right-hand side of the slide shows some of the announcements we made over the last 3 months. Our market-leading operating system for virtualized IP application, Ensemble Activator is now commercially available enabling operators to harness the power of disaggregated cell site gateways in their expansion towards 5G. Also in the context of 5G, we made further enhancements to our Oscilloquartz portfolio delivering unprecedented precision timing and networks with ePRC and ePRTC support coupled with new software releases. Our FSP 3000 provides highly resilient connectivity throughout Iraq and one of Europe's most important Internet Exchanges uses our fiber monitoring solution to increase service reliability and efficiency of their entire fiber infrastructure. Last but not least, we have an interesting use case in Australia, which we won where open fabric module is used to offer low-cost long haul connectivity and grooming. Our success is built on a well-diversified customer and product mix. Our solutions are very competitive, and we have won numerous new accounts to offset the global recession that we have been facing for the last 6 months. The expansion of our footprint in the global network infrastructure is of long-term importance as we are laying the foundation to further compensate any further weakness of the markets, moving into 2021. Finally, I want to say a few words about de-globalization, a trend that is having a significant impact on our industry. As early as 2019, we had already started to rebalance our value creation outside of China in response to US trade policy. These measures were costly but gave us additional flexibility and agility, and they made us less vulnerable to regional lockdown regulations faced throughout the COVID-19 crisis. We will continue to evolve the strategy of global value creation into Europe and the US, thus lessening global dependencies. And finally, we take our brand promise to be a resourceful network innovator and trusted partner very seriously. Customers value our reliability, creativity and ability to work closely with them on the network build outs. The trend towards more local value creation is positive for us and provides additional tailwind. My last thought is on sustainability and the role ADVA is playing to support our planet. We continue to win awards and commit to ever-more stringent carbon emissions output. Our latest commitments to the Science Based Target initiative is for us to drop our carbon emissions by 4% each year over the coming decade. We lead by cooking up the best technology solutions in our market segment and we are responsible for cleaning up after we have finished the creation of our gourmet solutions and delights, just like we all act in our own kitchen. And with that I gladly hand over to Ulrich for the financial segments. Thank you very much.

Ulrich Dopfer, CFO

Thank you Brian and welcome everybody. I will now guide you through our Q3 financial results. As already stated in the beginning of this call revenues in Q3 2020 amounted to EUR146.7 million and were slightly up from EUR144.3 million in Q3 2019. There are two important things I wanted to highlight regarding our Q3 revenues. Firstly, the impact of COVID-19 driven supply constraints in Q3

was smaller than in the previous two quarters, and we started to catch up with the previously mentioned delayed shipments and secondly the FX effect due to the weaker US dollar translated to about EUR4 million lower revenues. When we look at our cost of goods sold, here of course we benefited from the weaker US dollar, but also from the US tariffs due to the relocation of production facilities out of China, which helps us to offset some of the still much higher than normal freight costs. Consequently, pro forma gross profit contribution, increased to EUR51.9 million up from EUR49.1 million in the year ago quarter. On the OpEx side, our cost improvement measures introduced in 2019 continued to show the expected effects and combined with the lower discretionary spending, we managed to achieve a pro forma operating margin of 7.5% up from 5.1% in Q3 2019. Net income for the quarter was EUR6.7 million compared to EUR2.2 million in the year ago quarter. Consequently, earnings per share increased from EUR0.04 to EUR0.13 year-over-year. Please keep in mind that Q3 2019 was negatively affected by EUR2.5 million one-off expenses due to the introduced cost improvement measures. Net debt including IFRS-16 improved from EUR74.9 million in Q3 2019 to EUR35 million. The strong cash flow generation in 2020, increased our cash position by roughly EUR30 million year-over-year.

Next slide please. Quarterly revenue and pro forma profitability.
Demand developed according to our expectations and revenues have reached EUR146.7 million, an improvement of 1.6% compared to the year-ago quarter and up by 1.1% from EUR145 million in Q2 2020. Gross margin further improved from 34.6% seen in Q2 2020 to 35.4% mainly due to the effects I explained on the previous slide. Pro forma EBIT margin improved from 7% in the previous quarter to 7.5% compared to the year ago quarter pro forma EBIT increased significantly by 50%.

Turning to the balance sheet, Q3 2020 credit metrics remained strong with an equity ratio of 49.3%, further improved gross leverage of 1.0% in Q3 2020 came down from 1.11% in the previous quarter this indicates a solid investment grade profile. Thanks to the strong free cash flow generation of EUR11.2 million in Q3, we were able to repay EUR5 million of our revolving credit facility in addition to our standard repayments and still maintain our cash balance. Year-over-year cash and cash equivalents significantly increased by around EUR30 million. Liabilities to banks, the EUR73.7 million and IFRS lease liabilities were EUR29.6 million and make up our total financial debt of EUR103.3 million. Further credit lines are available if needed. Our working capital improved from EUR127.9 million in Q2 2020, to EUR124 million and represented 21.3% of revenues in Q3. Our year-to-date ROCE was 5.1%, and ROCE for the quarter was at a record level of 10.4%.

Turning to the quarterly operating cash flow development. 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 Q3, operating cash flow continued to be strong with EUR25.1 million and improved by 178% year-over-year. This is mainly due to higher earnings and the aforementioned improved working capital.

Next and final slide please. Over the last 9 months, we learned a lot about to best maneuver and the boundary conditions, caused by the pandemic. Despite various bottlenecks and challenges in parts of our production and supply chains, we have managed to service our customer orders although sometimes with delays. The partial relocation of production facilities out of China in response to the trade policy gave us additional flexibility and agility and made us less vulnerable to reach the lockdown regulations. The revenues with CSPs were comparatively strong in the first 6 months of 2020 as home office, the increased use of e-learning or video platforms and other related trends resulted in a significantly higher network utilization. However, we already pointed out that we might experience pockets of slowdown in demand from this customer group in the second half of the year. Further, we remain cautious about our business with large enterprise customers. In some industries, the economic uncertainty is leading to a slowdown in IT investments. The evolving second wave of infections in many countries is worrying and makes the impact on our business once again, more difficult to

predict. However, with 10 weeks left in the quarter, we want to provide you with the current outlook for the remaining financial year. Therefore, we decided to issue a revised guidance for the full year 2020. We now expect revenues between EUR555 million and EUR580 million and a pro forma operating income of between 5% and 6% of revenues. This revised guidance assumes that the impact of the pandemic on our business will not significantly worsen beyond the levels we have already experienced in the past. As a reminder, originally we had anticipated revenues to exceed EUR580 million with a pro forma operating income above 5% of revenues. Thank you, and now, I hand over to the operator to open the Q&A session.

Operator

Ladies and gentlemen, at this time, we'll begin the question-and-answer session.
(Operator Instructions)

Q&A

Operator	And the first question comes from the line of Simon Scholes of First Berlin. Please, go ahead.
Simon Scholes	Yes, good afternoon. Thanks for taking my question. I've just got one. You were referencing your largest US competitor earlier on in the call and it looks to me, that on the basis of his guidance and your guidance, you expect to gaining market share in the latter months of this year from that US competitor. You've talked about product wins. Obviously, your geographical exposure is different. I was just wondering if you could give some additional colour on your view as to where those market share gains are coming from.
Brian Protiva	Sure. Clearly, we're not taking market share from Ciena. It's a totally different animal from ADVA but we, I think, are technology innovation leaders. We have picked our battles in areas where we think we can win new customers and essentially what we're doing to, right now, maybe outperform in the market. We still don't really know, from a global market perspective, where that TAM is and the growth of that TAM because there are many different factors out there but we're able to win enough smaller deals, medium-sized deals to compensate for some of the slowness that we're seeing in the US or at particular CSPs. Again, I would never venture to say that we're taking any market share from the big boys but ADVA is doing well to guide our path. I feel like we have the opportunity to continue to do that but we're going to have to work overtime to make that happen, as long as the economy remains fairly weak.
Simon Scholes	Okay. Thanks very much.
Operator	The next question is from the line of Michael Junghans of Commerzbank. Please, go ahead.

Michael Junghans: Yes, thanks for taking my question, gentlemen. I would like to know a little bit about the change in the current revenue dynamics, what you mentioned, because in 2019, if I see here, we could see that the revenue dynamics, they gained in momentum as you went from Q3 into Q4. Could you elaborate a little bit on the increased headwinds you are currently observing on your demand outlook with respect to, for instance, regions and why some of your customer groups would now become more restricted on spending their remaining capex budget now, in Q4? Thank you.

Brian Protiva: So, two aspects of that. One, we've said, and I think the industry as a whole have supported our thinking, and that is people flushed spend in Q1 and beginning of Q2 when they were worried about supply chains being disrupted from the pandemic. We've been announcing that and talking about that for the last six months.

So, that's one aspect of it I think we, as an industry, face is there's not necessarily more money out there. In fact, if anything, I think there will be more conservative budget planning by the CSPs in particular regions because we're in a recession and in a recession there are less customers and the models change. So, that's one aspect of it.

We haven't committed to say that Q4 is a slowdown at all to Q3. What we've said is that orders slowed down in Q3 but on the year-to-date we're doing well. That was my statement in my presentation and as long as Q4 turns out to be a normal uptick from the Q3, ADVA will be doing very well.

But, we can't sit here today and say that's going to happen because there's a lot of people worried about Q4 and I think we've been conservative from day one in the pandemic to understand there's many moving parts, many factors to look at and we're guiding with a larger range because of the fact that there's a lot of moving parts.

I don't think, though, you should conclude that Q4 is then slowing down further or as much. It's just at this point we don't know that exactly. Having said that, we've done all the things necessary to make sure that Q4 turns out to be a good quarter for us from a profitability and from a cash perspective.

We're very focused on the business, very focused on day-to-day information coming off of the markets, adapting our model, and ADVA is well-positioned to exit this pandemic stronger than we entered it. I think that's the key message I would like to make, instead of trying to guess where the economy is going to go and how our industry is going to respond in Q4.

Michael Junghans: Yes, thank you. I would also like, a little bit, to know about your

business in Europe outside Germany. We could see some signs of market softness in Q2 this year. Has this demand softening now become a little bit stronger now in this region outside Germany in Q3, in Europe, especially?

Brian Protiva

I think our messages were, over the last nine months that, yes, Southern Europe was more challenging than it had been in the past and that has to do with a lot of reasons but clearly the pandemic hit them harder and their economies, of course, were impacted by that, so that's one aspect of it.

Then, we're slowly moving through a weakening US, which we had said strong first half, slower second half. Having said that, if you really look at it, and I made that comment in my presentation, is that the weakness in the US from a numbers perspective is not even that big. From a US dollar perspective, we might even have had slight growth but it being converted back into euros meant that we did have weakness from North America.

So, the answer to your question is, I think, right now we'd be most worried about the United States, second, most worried about Southern Europe, and we're hoping for continued strength in Central, DACH regions, Northern Europe, Asia-Pacific because we don't have that much exposure and we're winning some deals there to get further growth from those areas.

Michael Junghans

Okay, great because, about Asia-Pacific, I guess your customer concentration is not that high in this region. I'm wanting to know about how sustainable double-digit growth what you've posted so far in these nine months could be over the next few months. I'm not sure whether you could give us some kind of hint on how much of revenue is concentrated with the top three, four, five clients in Asia.

Brian Protiva

Uli, do you want to take that, the top three, four, five customers and I can talk about Asia while you look at that, maybe, for a second.

Ulrich Dopfer

It's very simple. We have a couple of larger customers in the Asian region and, as you said, it's a little bit more fragmented and I would say the success in this region of course depends a little bit more on the success in some of these larger customers. Having said that, there's also, of course, enterprise projects which come and go on a regular basis and sometimes you win a project and you see a spike in that region and sometimes you don't have it, then you have lower revenues. But, again, we have two larger carrier customers in that region and I guess a big portion of that revenue depends on those customers.

Brian Protiva

Adding to that, synch and timing is strong in that region. We're winning a lot of deals, also to Tier 1s, Tier 2s. We hope to be able to leverage that with some of our other products. Once you have

	a contract or a partner in place it's easier but it's still a big challenge and, of all the regions, probably hardest for us to forecast because we don't have as much breadth. It is very price competitive and decision-making is a little bit different in Asia-Pacific than it is in the Western world.
Michael Junghans	Okay, thank you. I will go back to the queue, so far. Thanks.
Operator	The next question is from Tim Savageaux of Northland Capital Markets. Please, go ahead.
Tim Savageaux	Hi. Good morning or afternoon. A question, Brian. You mentioned more TeraFlex wins and I wanted to kind of focus on that for a moment and see if you might be able to provide us with any additional colour on the magnitude of that product line for you, either in terms of how that's grown throughout the year, where it stands in terms of revenue contribution and materiality and, overall, what sort of demand you're seeing among either cloud or carrier providers for very high speed solutions 600 Gbit/s, 800 Gbit/s, 1.2 Tbit/s or what have you. Thanks.
Brian Protiva	In the beginning there was a lot of discussions within ADVA. This product is only made for a couple of big boys because it's so scaled. Our in a 1RU, it is just massive scale. So, a 3.6 Tbit/s in a 1RU chassis. Wow. Who can actually use that kind of capacity? And, days go by and weeks go by, months go by and bandwidth keeps growing and all of a sudden we're selling TeraFlex into a large portion of our customer base at this point. So, it's moving out beyond just the opportunity at the big cloud guys into many different opportunities for us and so, slowly but surely, that's growing. Millions of dollars will go into the tens of millions here shortly. It's making a difference for us in a bigger way. We haven't won one of the bigger players with that product as otherwise you would see that on our numbers. Our success is broad-based, very distributed, slowly strengthening our gross margin. So, lots of good things and naturally we'd want one of the big players with our TeraFlex. We think our solution is fantastic but because of some technology upscales changing, some of the things happening that you know very well, 400 Gbit/s ZR, open systems, all sorts of things that are transforming buying patterns means that there are decisions going on out there in this space that ultimately we'd all like to win and we'll see just what our chances are of winning a bigger footprint. TeraFlex is moving along. New features, new data rates, new cost points. We have a very rich road map. We find if very, very competitive against all other offerings. I've been saying this for a long time that 400, 600, 800, 1.2 Gig discussion is just secondary and there are many other things that are influencing purchasing

patterns.

Again, what are we talking about? Some of the competitive position is 400 Gbit/s ZR. We talk about 800 Gbit/s but actually maybe some of the big boys even go in a different direction and it's just a module of 400 Gbit/s. So, there's a lot going on. We're doing well with the TeraFlex, it's influencing our sales numbers nicely, i's moving out to many customers and we see it as a very competitive platform going forward.

Tim Savageaux

That's great colour and thank you for that. Just to follow up on that quickly and then I have one more question. It sounds like you're saying that for the big guys, in particular, there's kind of a range of technology options facing them, whether it's new 800 Gbit/s technology, plugables, what have you.

Now, along with what we've seen as a trend towards kind of maintaining status quo, adding more capacity in terms of what's installed and operationalised and maybe waiting until next year to address some of these new technologies, it sounds like you're saying that's maybe delaying decision-making. Is there a sort of a timeframe that you're focused on when some of these larger architectural commitments on the part of the big cloud guys get made next year?

Brian Protiva

Again, the larger guys, they're not all aligned in the same path forward. There's 600 Gbit/s, 800 Gbit/s, 400 Gbit/s ZR, open systems. There's a lot going on. Just do a little bit of what we've already done at 400 Gbit/s. There's a whole slew of strategies out there and I just think it's evolving and we'll see, really, the models that gain the most strength.

There's own built systems, discussions about building our own systems for highly scaled players. So, there's a lot, as you say, Tim, of let's say optionality and ADVA is competing for a number of pieces that we can compete for, we can't compete for everything but compete for, and we hope to grow that space.

But, there'll be ups and downs. We're not dependent on it. It's one of our three customer segments that we are addressing. It's one of two that's been doing pretty well, even through the pandemic and, yes, we have lots of technology that's been designed that could be used by them very effectively, and not just standard optical stuff but also timing, fibre monitoring, other pieces that we're looking at bringing into those organisations to address their needs.

Tim Savageaux

Great. And, the last one from me, and this is kind of an ADVA financial-specific question. You've had some further improvements in gross margins in the quarter and just overall profitability. Part of that is opex control but, either in Q3 or if you look at what's implicit in your annual guide in Q4, margins look to

be increasing there, as well.

I wonder if you can maybe differentiate between what might be gross margin expansion expected there versus further opex control and, in general, discuss gross margin dynamics given your comments around weakness in the cloud side. That's a higher margin business. It seems like you've had some reasonably good mix thus far this year. I wonder if that remains the case and you expect gross margins to expand further in Q4?

Ulrich Dopfer

I guess I start. I would assume similar gross margin in Q4 and what's driving the gross margin, of course is, as always, customer and product mix, regional mix, but then we're working hard on getting our costs down and cost reduction programmes. Then, on top of that you have now, especially in the second half of the year, you have the weakness of the US dollar that will help us.

We spoke about the location of production out of China in order to keep tariffs into the US down or low, and then we are deciding and hoping going forward to improve our gross margin further and sales costs normalise. They are still, by a factor of two, higher than in normal times but overall, again, I would expect a similar gross margin going into Q4, could be a little higher, could be a little lower but it should in that magnitude.

Tim Savageaux

Thanks, very much.

Ulrich Dopfer

On the opex side, I guess that was the second half of your question, I would assume opex to go down slightly in Q4. I guess one important message, and we spoke about that in the last quarter, there was a question last quarter in regards to the earnings based on R&D capitalisation.

Currently, we always said in the second half of the year this should level out, the capitalisation and the amortisation effect. We still have smaller gains in Q3 but this should reverse in Q4, so we should be almost zero in the second half of the year when it comes to EBIT effect of the R&D capitalisation. So far, for the first nine months of the year, we basically are roughly half of the R&D net cap effect than compared to last year. So, the R&D capitalisation already makes a smaller impact on our profit this year than last year.

Tim Savageaux

Got it. Thanks.

Operator

As a reminder, if you wish to ask a question, please press * and 1 on your telephone keypad. The next question is from Jon Lopez [unclear 00:17:47]. Please, go ahead.

Jon Lopez

Hi. Can you hear me okay?

Brian Protiva

Yes, we can.

Jon Lopez

Oh, great. Sorry. Thanks. I wanted to start out just with a clarification. My recollection was, and I'm just going to back a little here, my recollection was calendar Q2 there was shift of, I think, perhaps €10 million from Q1 as COVID-related implications. My further recollection was between Q2 and Q3 there was something on the order of €15 million expected. It sounded like during the prepared remarks that was perhaps smaller but I'm wondering, can you just refresh my memory on that cadence and, then, I'm wondering what the implication between calendar Q3 and calendar Q4 is? Was there any of that activity that extends beyond the third quarter?

Ulrich Dopfer

Your recollection is correct. We had about €10 million of revenues moved out from Q1 into Q2 and about €15 million from Q2 into Q3. However, last quarter we already said that it's getting a little bit more blurry, so we definitely had some supply issues in Q3, as well, and we probably weren't able to shift €8-10 million but it's difficult for us to say is this now based on COVID.

It was easy for us to say in Q1 because we could easily say everyone was shut down so we didn't get our supply there. Now, the entire supply chain is much more complex, much more fragmented and it's a little bit more difficult for us to say is this now based on COVID or is it just based on a normal constraint for certain components or in certain regions. So, it's a little bit difficult to say but I think the magnitude was about up to €10 million that we're able to ship or invoice in Q3 based on what sort of supply constraints there were.

Jon Lopez

Okay, got you. That's helpful. Then, my second question, just geographically, can you remind me. My understanding or, at least, historically, was most of your ICP exposure is within North America. Is that still a fair characterisation or is that a bit more geographically diverse?

Brian Protiva

Well, we view it that way but they're a global company, so you can also break that down differently but the decision-making is done out of the United States. So, yes, the ICP decision-making is done out of the United States and we attributed that to the team in the United States but we do break that down then when we know things are shipping in other places, other regions.

Jon Lopez

Okay, got you. Then, I suppose my two broader questions are, if you think about the places where you're seeing demand pause, so use maybe North American service provider as perhaps the prism here. I'm wondering your view on duration and, perhaps, implication to 2021. I realise it's probably too early to talk about next year but can you just discuss, for a second, the cross-currents, and I think you highlighted them. Obviously, on the one side there's business pressure, on the other side there's network pressure. Just talk a little about how, perhaps, you think these

	things resolve as we look out into 2021.
Brian Protiva	I guess there is, for me, two aspects of it. One is the actual use of budget in 2020 where people panicked a little bit and then flushed some earlier in the year and now pulling back. That's one thing happening in the United States. The second thing that's happening in the United States that there is a massive 5G rollout. T-Mobile is changing the world and you've got people like Verizon and AT&T responding to that, which means they're shifting dollars and spend into 5G infrastructure rollouts. So, that can have an impact on optical. If you do less optical core investment dollars you still invest in optical and packet and, let's say, backhauling from midhauling and fronthauling but it is less dollars probably spent relatively to the total dollars spent when you start shifting like that. That, to me, is maybe a year to two-year discussion and you guys need to do more work on that with Verizon and AT&T as they respond to T-Mobile who is going crazy, blazing guns, to win the 5G war. So, again, two different issues, both need to be managed. I would think the budget issue and, let's say, the frontend loaded thing, that ends with January 1st. You have pretty healthy balance sheets in the United States because you have more consolidation. Therefore, I would imagine that budgets start to flow up again starting in Q1 already and, if you underinvested in the second half, then maybe even it starts to get healthy again in the first half of next year. But, the bigger issue might be that 5G-focused spending, at least with the two or three big guys, and that means people that are exposed to those people have an added challenge to read that and deal with that going forward.
Jon Lopez	Really, helpful.
Brian Protiva	Ultimately, it catches up again, right?
Jon Lopez	Right. Sorry to interrupt you. Really helpful. The other thing I wanted to just have you talk a bit about is within your enterprise. Here, again, my recollection is that financial services as a vertical is relatively important I think in the context of enterprise, in total, which is perhaps a quarter of your business. Can you just remind me if I'm correct on that? Then, if you could talk a bit about, perhaps, that vertical within the trending you're seeing in enterprise. Is that behaving materially differently from the balance of your enterprise customer group?
Brian Protiva	Enterprise, that's a complex one, right. Our packet world is very dependent on the enterprise world again but it's more of a resell through the service provider into the enterprise space. So, let's talk about direct selling to enterprises and that's with partners and it's usually large enterprises, so that 25% that you indicated,

because we're actually exposed indirectly more.

One of the challenges that we've had this year is two of our three tripod legs are outperforming, optical and synchronisation, but the edge cloud or the packet area has underperformed some because of weakness in that small to medium-sized enterprise segment.

In the large enterprise segment, finance is an important piece of it and, if you look at the industry right now, the sense is financials continue to spend nicely and you guys are reading the analysts' reports as well and we're realising this personally. The financial companies have to spend, are spending, will spend on IT, are driving to drive up efficiencies, get rid of employees, change business models, etc, etc. So, IT is fundamentally important for them for that transformational change to digitise their worlds, so that's good.

Then, things like government. Government, federal especially is investing and in Europe most of it is federal, versus in the United States, states usually spend a lot but they're weak, federal is still strong. So, you've got certain verticals.

We think energy comes back fast and nice very quickly because they've got distribution, contribution network challenges, so they need to spend for transformational change but you're going to have places like retail, travel, leisure and other pieces that are going to suffer some. The car industry is one of those suffering in the big picture. We do a lot of business in the car industry as a whole but that's one that people have pulled back on as the world is changing there.

So, to an answer, finance good, important for us. We're well positioned. It's stable. Again, it's not the biggest market that we address. Enterprise is a much small market space than carriers and/or the ICPs, clearly, but we do very well there and, in fact, we've added a number of solutions to go after that space, synch and timing for one, as an example, but also even packet as we move into the space, we're in it, but move in it and try to broaden our penetration into that space.

Jon Lopez: Got you. Sorry, could I just clarify. Not to put words in your mouth but would it be fair to characterise, perhaps, your enterprise caution as federal and financial okay, all other kind of bearing the brunt of, perhaps, the slowdown?

Brian Protiva: I would say federal yes, financial, energy or I'd say government, because in Europe it's not the federal thing.

Jon Lopez: Sure.

Brian Protiva: And, government is good to go and will continue investing and all others are struggling. Having said that, the large enterprises don't

cut back as hard. The small to mediums are cutting back harder.

Jon Lopez: Got. Okay. I'm sorry, I have one last one. Hopefully, very quick. Could you speak a bit about inventory? You have not brought it down much and there's obviously all kinds of concerns, or there appear to be recently about availability issues, again. I'm wondering what your penchant is going forward. Are you looking to restock? Are you looking to carry excess levels of certain things, all things? Just as you think about inventory and any implications for cash flows, as you think about the next couple of quarters, could you just talk about your mindset?

Ulrich Dopfer: You start, and I'll follow up.

Brian Protiva: Well, I think sourcing of components of certain things have been a struggle but, in general, we're doing better than six months ago. There's still a struggle on certain areas but I don't think we have to fundamentally stock up across the board. I think there's certain projects and customers where we need to build more buffer and build more capability but it's definitely not across the board. How that works out from a COO, CFO planning, I'll leave to Uli to answer.

Ulrich Dopfer: If you look at it, we brought inventory down quite a bit. We saw last year, if you recall, we have increased quite a bit. Due to the US tariffs, we tried to pre-purchase and move stuff over to the US. Also, in regards to Brexit, we increased our stock levels by about 10-15 million last year, so now, third quarter, we are five to six million below last year end of the third quarter.

We are managing our inventory tightly and our cash tightly. My goal is not to increase inventory drastically based on component issues or so. We learned a lot during the pandemic and I said the supply chain is more complex and more fragmented, but every month we're learning and we're getting better and better. So, I would not assume that our inventory levels will increase over the next couple of quarters drastically.

Jon Lopez: Great. That's really helpful. Sorry for taking all the time. I appreciate your help.

Operator

And this concludes the question-and-answer session. I hand back to Mr. Brian Protiva for closing comments.

Brian Protiva

I'd like to thank you for all the great questions. I hope it makes things more transparent and Go Go Go ADVA and I appreciate you guys joining the call.