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ADVA Optical Networking, Second Quarter 2021 IFRS Financial Results

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PRESENTATION

00:00:03 Operator

Dear ladies and gentlemen, welcome to the conference call of ADVA Optical Networking for the second quarter, 2021 IFRS financial results. This call is being recorded. As a reminder, all participants will be in a listen only mode. After the presentation, there will be an opportunity to ask questions. May now hand over to Mr. Steven Williams, ADVA Optical Networking Director Treasury and Investor Relations, please go ahead sir.

00:00:39 Steven Williams

Thank you and welcome to ADVA's Q2 2021 financial results, conference call. In addition to this call and the press release, we have posted a presentation which is available for download from our homepage, ADVA.com, on the conference call page, and the financial resources section of the 'About us' / investor section. Before turning the call over to Brian, please be reminded that 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 report, 2020. Please also be reminded that we provide consolidated proforma 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 proforma 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 losses calculated prior to non-cash charges related to the stock compensation programs and amortization and impairment of goodwill and acquisition related intangible assets. Non-recurring expenses related to restructuring measures are not included unless stated otherwise, all numbers are represented in euros. We will target to limit this conference call to 60 minutes. As usual, Brian will start and provide a business update. Then Uli will talk us through our Q2 financials and outlook. And finally, we will have sufficient time for your questions, which we'll be happy to answer. And with that, I turn the call over to Brian. Please go ahead.

00:02:32 Brian Protiva

Thank you, Steven. We will start with page four Q2 2021 highlights. Today, we report business figures that fill us with a sense of accomplishment and pride. Despite continued challenges on the supply side, our revenues are up, and we have never achieved higher profitability in any other second quarter in our company's history. Our quarterly revenues were up 3% year over year and reached €149.4 Million. Pro forma operating income increased significantly by 42.6% compared to the year ago quarter, now reaching 9.7% of revenues. Furthermore, we had excellent cash generation, which makes us net cash positive for the first time since applying the IFRS 16 accounting principles. Actually, we reached almost 30 million positive net cash when looking at us from a US GAAP perspective. After a long and exhausting third wave, the number of covid-19 infections is decreasing in many regions of the world. Nevertheless, the fear of new mutations and setbacks persists. The state of the world economy is still inconsistent and characterized by great uncertainty, however, with the help of our technology, our customers continue to develop and expand high performance digital infrastructures. The pandemic related lockdown measures made it clear that companies, industries, and regions that have progressed further with their digitization efforts coped much better with the changing conditions, while less digitized business models and companies dependent on legacy processes were often left behind. This realization accelerated the digitization efforts in many places and the willingness to invest in network expansion continued in the past quarter. As such, we see strong incoming orders from all regions and in terms of our technology areas, the picture is more balanced again across our technology tripod. ADVA is financially stronger and has momentum, our company is on a trajectory of growth with solid, long-term profitability.

Next slide, page five, business transformation update: growth in private enterprise networks. At our Capital Markets Day in March, we outlined our business transformation strategy, which is essentially built on three pillars: accelerated growth outside the classic telco infrastructure with a special focus on security-first networks; increasing sales contributions from software and services; and new market and cost optimization through verticalization. In today's call, I will provide a few examples that underline our progress with this strategy. First, growth and new applications outside of the telco infrastructure. Communication service providers are our most significant customer group for ADVA, and we are fully committed to supporting the network expansion into 5G and beyond. With some of the Chinese competitors being limited in Europe due to security relevant issues, we see additional growth potential here. But on top of that, ADVA has always had a strong track record in private enterprise networks. Some industry analysts call us the original DCI company, the data center interconnect experts. For many years, we have been the global market leader in this interesting market segment. More and more industries are seeking to build a trusted network infrastructure that they can own. The pandemic accelerated these efforts, and we see the trend away from a cheaper supplier strategy with preference for technical leadership, local content, and trusted partners. The ongoing industry consolidation has further strengthened our differentiation in this segment and beside our historic strength with the financial service industry, we are also seeing more and more success with research and education networks as well as government projects.

Moving forward to page six, Business Transformation Update: Opportunities in critical infrastructure. I want to expand a bit more on the concept of trusted network infrastructure. Many of our customers in the private enterprise segment are transporting mission critical data and need a partner that offers more than just technology. That creates new opportunities for us. ADVA has all supplier credentials, including country of origin certificates, government approved design, manufacturing, and logistics processes in order to fulfil the requirements for this opportunity and more. In addition, we have a great partner landscape with proven interoperability, monitoring and actions guaranteeing end to end performance. And of course, we provide innovative technology with market leading security features. A few weeks ago, we introduced our market first FSP 3000 Quantum Safe Connect Guard encryption technology. The solution answers the urgent threat posed by quantum computers and gives organizations a way to safeguard their networks before the danger materializes, our customers data will be fully protected, even from cyber criminals intent on harvesting information, so that they can store it today and exploit it tomorrow. We are providing long term security for data in motion. Our investments in such new technologies give us access to new markets in which we can operate in highly differentiated and thus profitable manner with growth rates above our corporate average.

Next page, page seven, Business Transformation Update: Expanding both software and services. Another important pillar in our business transformation strategy is the expanding revenue contribution from software and services. As I mentioned in the previous call, the contribution from software and services increased from 20% to 23% in 2020. And of our almost 1,000 engineers, more than 60% now work in software development. As networks are becoming more powerful and complex, our customers seek ease of use and higher levels of automation, lowering the efforts of operating these networks. So the value creation of software is increasing. In addition, we are leveraging new tools and products such as our state-of-the-art software licensing platform. What's more, our network operating system, Ensemble Connecter and Ensemble Activator are gaining commercial traction. With our Ensemble Activators Software, a network operating system for the expansion of 5G networks, we scored two important customer wins. One of them was publicly announced. You can see a screenshot on the slide. Telefonica is working with us to deploy Disaggregated Cell Site Gateway solution DCSG, or commonly known as DCSG, as part of Telefonica transform fusion IP network architecture. These wins marked the beginning of the commercial introduction of disaggregated cell-site gateways by international mobile network operators and are important milestones for the implementation of open network architectures in 5G.

And moving to my last slide, page number eight and The Supply Chain: Update and challenges. While our order books are at record levels, supply chain complexity remains very high. In particular, the bottlenecks in the supply of semiconductors are causing enormous stress in purchasing, production, and logistics, requiring intense focus and creative solutions. We are fighting hard to secure all the components we need for Q3, 2021 and beyond. We are slowly solving our challenges as we have a fantastic team wrapped around these issues, creating solutions, and allowing us to ship our products, as we demonstrated in Q2. Nevertheless, we could not ship a material amount of product that was requested in Q2, and our backlog continues to grow. We hope to have seen the worst of the crisis in Q3 and that things will slowly stabilize in Q4 and beyond. We are in close contact with our customers, who are now placing their orders much earlier than usual, and we are optimistic that the situation will begin easing towards the end of the year. To summarize: we continue to grow our business showing profits and building our financial resources. The macro environment for our industry continues to be good. The digitization efforts in many global regions are in full swing and the expansion of communication infrastructure is moving at speed. Security is on the top of our customers digital agenda, and we are sharpening our profile as a supplier of choice for trusted network infrastructure. With a record level order backlog, we will continue to use all our strengths to produce results that allow us to be a leader in a consolidating market. And with that, I would like to pass off to Uli. Thank you very much.

00:13:01 Uli Dopfer

Thank you, Brian, and welcome also from my side. Let us move to slide 10: Key Financials. Revenues in Q2 2021 reached €149.4 million, up by 3% from €145 million in Q2 2020. Despite the challenges related to the semiconductor crisis, we have managed to grow both quarter over quarter and year over year. Unfortunately, and as Brian stated, our Q2 performance was limited by a material amount of delayed shipments. On the positive side, we experienced strong order intake from carriers and enterprise customers throughout the quarter, and our backlog reached another record level. The silicon shortages also presented us with challenges on the cost side. Additional trade and purchasing costs for components amounted to a mid-single digit million number. However, we were able to absorb these additional costs and increase proforma gross profit by 14.1% to €57.3 million compared to Q2 2020. This result was only possible based on further progress with our business transformation strategy leading to a software and service revenue contribution of 24% and a more favourable product and customer mix in general. Q2 was again a record quarter in terms of pro forma operating income, we achieved 9.7% of revenues, up from 7% in the year ago quarter. In addition to the strong gross profit, this substantial margin improvement also reflects our strict and proactive cost management. Net income reached 12 million significantly up by 57.3% from 7.6 million in the year ago quarter. From a year-to-date perspective, net income reached €23.2 million and exceeded the net income of 20.3 million for the full financial year of 2020. Consequently, earnings per share for Q2 increased from 15 cents to 23 cents. Cash generation and deleveraging was once again excellent, and we reduced our net debt by 48.8 million compared to Q2 2020 and now report a net cash position of 3.9 million for the first time since the introduction of the IFRS 16 standard in 2019. Excluding IFRS 16, this corresponds with a net cash position of €29.8 million euros.

Next slide, please. IFRS versus US GAAP comparison. As explained last quarter, we added this slide for the purpose of transparency and to make our numbers comparable to our peers, who report in US GAP. Just as a side note, the US GAAP numbers here have not been audited. Under IFRS we capitalized and amortized parts of our R&D expense, impacting gross and proforma EBIT margin. Our Q2 gross margin under US GAAP would have been 45.7% compared to 38.3% under IFRS, and proforma EBIT margin would have reached 10% of revenues.

Next slide, please. Regional Revenue Development. EMEA revenues significantly increased by 24.8% year over year, now representing 64.5% of revenues in Q2. Similar to Q1, we had a very good quarter with enterprise customers, particularly governmental customers, but also carriers continued to be strong. The Americas region is still below expectations and decreased by 23.8% year over year, now representing 27.9% of revenues. We still experienced some temporary delays, softness with a few customers due to inventory management and the adoption of next generation equipment. However, as expected, revenues in the Americas increased by 13.5% compared to Q1 2020, Q1 2021, with order entry being strong. Asia Pacific also decreased and was 13.6% lower compared to the year ago quarter, now representing 7.6% of revenues.

Let's move to the next slide. Cash Flow and Balance Sheet, KPI's. We achieved a free cash flow of €14.6 million, compared to 23.4 million in Q2 2020. The difference is mainly explained by an increase in working capital and higher capex when compared to the year ago quarter. Nonetheless, our cash balance reached 85 million and increased by around 17 million year over year. As already mentioned, Q2 was the first quarter to report a net cash position of €3.9 million when considering the accounting standard IFRS 16. With a debt leverage ratio of 0.5 times EBITDA and an equity ratio of 53.8%, we have a very solid capital structure and further solidified our investment grade credit metrics. Q2 2021, year to date ROCE of 13% improved substantially, even compared to 2.5% in Q2 2020. This KPI is promising, and we are on track to deliver solid shareholder value.

Next slide and final please. Guidance. Despite the extreme challenges caused by the semiconductor crisis, we reported another successful quarter and once again proved our agility and flexibility. Our business transformation strategy introduced at our capital markets day, combined with strict cost control, is an essential part of transforming the business model to sustainably higher margins. The bottlenecks in the supply of semiconductors are still a major threat to the stability of our supply chain and can lead to revenue movements in the coming quarters. However, considering the very successful first half of 2021, the strong order backlog, and the positive outlook for the remainder of the financial year, we confirm our revenue guidance range of €580 million to €610 million and consequently narrowed the profitability guidance to range between 7% and 10% of revenues. With that, thank you and operator, please open the Q&A session.

00:20:08 Operator

Thank you very much, ladies and gentlemen, we are now starting the question-and-answer session. One moment, please, for the first question.

The first question is by Alex Henderson of Needham.

00:20:46 Alex Henderson (Needham)

Thank you. Nice quarter, guys. Congratulations. I was hoping you could talk a little bit about your commentary around the supply chain, given what has been going on with the covid-delta and particularly with shutdowns and flooding and a variety of other challenging events in the PAC Rim lately with Malaysia, Indonesia and China all seeing, you know, significant duress to their facilities and the like. Have you adjusted for those recent events in your guide or is that holding back the guide? How do you think about those events impacting the supply chain?

00:21:36 Brian Protiva

So clearly, that's a part of our plan, we are tracking all of that very closely. The fact that we do have record backlog enables us to be more flexible and, you know, figure out what we are going to ship and how we are going to ship it. We are not going to get everything out the door as we did in Q2. You know, building backlog is a positive for this environment. But clearly, it is limiting us, and the industry as a whole, and it is costing us a bloody fortune. You know, people, I kept saying, since Q1 this year, people saying, oh the pandemic is giving you extra, you know, lower OpEx, whatever else, and I kept pushing back and saying, you guys, but we have actually more costs this year than normal. And the costs of this whole supply chain management issue are greater than anything we are saving from the pandemic. And it is because of the reasons you named. But we believe we have it under control to the point where we have kept our 580 to 610, we have increased the profitability range, and so, therefore, we feel good about where we are sitting. And, yes, it has led to some unhappy customers because certain things do get pushed off then, which is not good. But we are working it with everything we can to make it up for those customers.

00:22:55 Alex Henderson

If I could just follow up on that. The question of mix comes up. Is there any delta between the enterprise products, your ability to deliver there and the service provider? It looks like your enterprise is doing quite well, but your service provider, if I take that out of your overall growth, was fairly flat. Is that a function of what parts are constrained?

00:23:23 Brian Protiva

It can be, but it doesn't have to be. So, if you look at it, you know, we have three business units that we talk about, the optical, the edge cloud or the packet-based products, and then the sync and timing products and all three of them are exposed to the telco. The edge cloud stuff was hit the hardest, you know, in the pandemic coming back out of it. But they seem the most challenged from the semiconductor area in that piece. But having said, we are challenged across the board, more in that piece, which is, that means the carrier gets influenced a little bit more because the edge cloud is a product we do sell on to some enterprise, but it's not relatively the percentage is lower than either our sync and timing business and/or our optical business. So you have got a little bit, two to three things in there. One is from a situation is, it can indirectly have an impact, but it doesn't have to fundamentally. We can use, you know, we leverage products in the optical space for both areas.

00:24:32 Alex Henderson

And one last question and then I'll cede the floor. I have heard comments from a variety of industry sources that Cisco is raising prices. And Cisco, in fact, made the comment that they were going to raise some prices on their last call and specifically heard that, despite their promises of not disadvantaging their customers relative to the Acacia products, that in fact, they're taking pricing up on Acacia products by as much as 10 to 15%. Can you comment on whether you are seeing any pressure or any change in behaviour post the Acacia acquisition by Cisco, and I will cede the floor? Thanks for the answers.

00:25:19 Brian Protiva

So, I think I am not going to comment actually on the supply piece. I think, you know, we have a very close relationship with the Acacia leadership team. They are still making decisions within their ... I think we have a good relationship. We are well respected. I am hoping that they live up to their commitments and expectations to us over the next couple of years. And that was agreed upon and even put in writing that, you know, that there is a strategic relationship there. So the first comment. But talking with Cisco and raising pricing and impact from their supply chain into the customers. We have heard various things about various companies. You know, it is hard to really understand, is it just a one off, or the one customer, because it does not map into what they can deliver, because of whatever the backlog choice of what they can do with the supply that they have, essentially. And that is a little bit more complex for us. I do believe that all customers are having the same problem. Not all of us are reacting the same. We are not going to increase pricing because we value our customers. It is all about CSAT and we want them to understand that we are willing to invest to maintain an excellent relationship there. So, again, I have heard lots of rumours out there. Let's see. Hopefully it actually benefits us. You know, if we are the one being responsible, living up to customer commitments and getting products to them in a fairly timely fashion. Yes. With delays and longer, longer delivery schedules, I think we win.

00:26:55 Alex Henderson

So you didn't see a price increase on Acacia modules.

00:26:59 Brian Protiva

Again, I do not want to comment on that supply chain, that specific question, I try to block it.

00:27:07 Alex Henderson

All right, thanks.

00:27:09 Operator

The next question is by Simon Scholes of First Berlin.

00:27:14 Simon Scholes (First Berlin)

Yes, hello. Thanks for taking my questions, I've got two. The first one is on the softness that you said you saw amongst some American customers. I mean, is this softness spread across several customer groups or is it restricted mainly to one customer group? I was also wondering if you could comment on what is happening vis a vis the ICP space in the States at the moment. And also, in Q1, you mentioned that software and services, I think, accounted for 26 percent of sales. I was just wondering if you could give us an update on that number for Q2. That's it, thanks.

00:28:08 Brian Protiva

All right, Uli, that with your comment around the American piece. You want to take it? You want me to take it?

00:28:14 Uli Dopfer

You can take it and I add in.

00:28:17 Brian Protiva

Okay, so, I think the American softness, I mean, we actually said we had booked nicely in the beginning of the year and stuff, we still see the Americas as returning, as you can see also from the revenues over the last couple of quarters are slowly increasing there. Yes, we have some softness if you exclude some of the advanced purchasing or ordering. But I think it is just the ebbs and tides of America returning them to normalcy. And I think it is coming back. We have not lost any customers there. You will see us continue to drive the US forward and we have got some really big opportunities there with especially some of our newer products. So I do not see this as a longer-term issue. But, you know, there are some things have taken longer, let's say, in, sync and timing, than we had anticipated. Some of the Ethernet area or the edge cloud area has pushed off. But in general, I think we are well-positioned, and we have got a bunch of new products that are specifically targeting and attacking the US market. So that is the first one. And the second one is from a software and services piece. We do not reach the 26% level. We were closer to the 24s percentage level, a little bit less software, a little bit less services. So we are still moving in the right direction, off of the 23%, making progress, and I personally called that out last time, the 26% was abnormally high, but it is a step forward from last year, making progress I would say in the first half, we’re like 25 point some x percent. We hope to stay in that kind of an area this year, maybe got even to 26% on an annual number. So this is 24, maybe a little bit lighter than the average, what we foresee for the year and also slightly down from Q1.

00:30:22 Simon Scholes

Okay, thanks very much.

00:30:25 Uli Dopfer

I guess I would probably only add to the to the Americas question, we are up in revenues compared to Q1 and of course also the Americas were impacted by the delayed shipments. So the Q2 numbers would have been higher without the semiconductor crisis. So, just this is an additional information.

00:30:45 Simon Scholes

Thanks.

00:30:49 Operator

The next question is from Robert-Jan van der Horst from Warburg Research.

00:30:54 Robert-Jan van der Horst (Warburg Research)

Hi, thanks for taking my question, a few of them actually. On the cost effect, especially on your gross margin of the chip shortage. I mean, you have had quite a good margin and I was wondering how great it could have been without the effects of the chip shortage to really highlight how much the product mix actually improved your profitability year. So is there some metric, how many percentage points in terms of gross margin, the price increases have actually cost you? Another question is, there is now, I have heard some concerns in the market that some chip manufacturers are actually quite happy with, like a little bit of shortage to keep the prices high. So do you anticipate that we will just not see more price increases, especially next year? Or do you think that even with the shortage resolving to some extent, the prices might more or less remain on the levels we saw this year? Thanks.

00:32:04 Brian Protiva

So I guess, you know, two aspects of this. One is the chip shortage is material. We said 10 to 15 million of kind of extra cost. But remember, it is always this ... we do not highlight one area because there is always offsetting stuff. You have got, again, the advantages of less travel and less event spending or you have got the advantage of, we had a pretty strong dollar in the beginning of the year. So, you guys, it is hard to say, oh, I am going to take that back that out and next year they are going to have, then, this much higher of a gross margin. I just say, you know, the puts and takes are kind of evening each other out. The real reason why our margins are higher is because of what we have been talking about, as you know, the business transformation, the software and the services, a lot of good non telco business, some of the verticalization stuff that we are doing. And that is the key. And I do not think that you guys should be looking and saying, oh, you know what this means 2% higher gross margins as 2% on there, because there have been some good things as well. So, again, I just want to make that statement as it is. It is having an impact. It is ... and the question is, does that impact a lot? So clearly, there are three aspects of the impact. There is the issue of just price increases. There is the issue of finding new distribution channels. And the third one, finding grey market any way we can, having to go and do our own burn-in stuff again. I mean, a massive amount of work increasing in operations to be able to guarantee the same quality, etc. So there are all sorts of things that are happening around there and therefore the costs are going to go down because you are not going to have that as things settle back in, I think it is quite hard for the semiconductor manufacturers to continue to, oh, I have got all this number and I am selling into the grey market to sell to our customers. The customer is going to get upset. At some point that has to go away. That is a short-term issue. So there are some ... two or three are definitely going to go away, do some higher prices, stick with us going forward. Yeah, some of that could well stick with us. But remember this is a competitive market. Remember China is coming on board, investing like crazy in semiconductors and these semiconductor players want to do that? Try to drive higher margins long term? I do not see that as a viable long-term strategy, personally. But who knows? I mean, who would have said we have these extra costs at this level a year ago? So, I guess it is not clear cut. And again, I do not think I would recommend for you to bake into any models that all this is going to go up by this and this much by this and this time. I would say in a year from now they are going to be better, but let's say some of the save’s costs through the pandemic are going to go higher again. We are going to do events. We are starting to do our first events this year, hybrid events, you know, limited people attending them and stuff. So you start to have this balance come back off of some of these extras out there.

00:35:16 Robert-Jan van der Horst

Perfect. Thanks very much.

00:35:20 Operator

The next question is by Michael Junghans of Commerzbank AG.

00:35:25 Michael Junghans (Commerzbank AG)

Yes, good afternoon, gentlemen. So I have got two questions, for the moment. The first is on products and customer mix. What we have seen in H2 is because concerning your gross margin of 38%, what you achieved on the first six months and given your positive outlook remarks on order intake, also, given your level of what factors you have spread it on, what is your view here, how the product and customer mix will likely develop over the next six months now compared with Q2 here? The second question relates to a likely tax rate, what we can see in 2021, so your tax rate in Q2 was, I think, little bit less than 5%. Do you see good chances that for the full year, we could end up with a tax rate of probably less than 10%? Thank you for taking my questions here.

00:36:17 Brian Protiva

Uli, I will take the first one, you take the second one. Product customer mix, you know, we have had a nice run in some of these security-first networks. And does that stay at that rate? Hard to say. I mean, we have got nice, different, lots of different opportunities, but from a product and customer mix, if things do shift a little bit, it is a little bit stronger edge cloud packet world and maybe a little bit stronger telco, as the edge cloud comes back. So there might be some pushing there, but I do not think it is a fundamental shift and we are focused on our business transformation, so we need to control our own destiny and make sure the pipeline is there for us, Uli.

00:37:06 Uli Dopfer

All right, tax rate, yes, the tax rate was extremely low. This has to do, I guess you mentioned it during last call, last quarter as well. It has to do that we can utilize NOLs in the ADVA SE. We have a lot of profits increased in the SE. You saw that with a strong EMEA business, so we can utilize NOLs, and we can also build us deferred tax asset based on the future expected earnings in the SE. So, yes, tax rate is low and will remain low for the year. If you want to model it, if you want to be conservative model with 10%, but we expect it to be below 10%, maybe around seven-ish on average.

00:37:53 Michael Junghans

OK, understood. Just to follow up on the first question with regards to the product mix. So, shall I take it such that if things stay as they were in the first half, you would not expect that products and customer mix would be worse than your high level order backlog what you can (00:38:16 unclear) look ahead to the second half of this year.

00:38:23 Brian Protiva

Yes, that is kind of ... Uli?

00:38:27 Uli Dopfer

I would say, you know, that gross margins in North America are usually lower than in the rest of the world or in EMEA. And so, I would expect with America getting stronger in the second half of the year, that our gross margins would decrease a little bit.

00:38:46 Michael Junghans

OK, understood. Thank you, so far.

00:38:50 Uli Dopfer

And also, maybe, you know, we will continue to incur additional costs based on the semiconductor crisis. I said we had in Q2, we had a mid-single digit million number here. So we do not know how this will develop, but it will, for sure, with expected volumes that we are going to ship or that we are purchasing, that this number might go up a little bit as well. So, I would probably model slightly more conservative gross margins.

00:39:21 Michael Junghans

Understood, thank you.

00:39:24 Operator

The next question is by Johannes Ries of Apus Capital.

00:39:28 Johannes Ries (Apus Capital GmbH)

Yes, good afternoon. Maybe some final questions from my side. On the order book, you mentioned, you have a record order book, how long is the duration? Have you always ... I know in the past, you have always short order lead times and maybe visibility of six weeks or so. How much has it increased? How much maybe even you have already orders for '22 and how much is a risk or maybe potentials that there is some double ordering because customers order more than they need to get anything. That is the first question.

00:40:05 Brian Protiva

I don't think there are people ordering more than they need. We do not see that anywhere. And we do some itemizing there and categorizing it, so we understand that pretty well. And like I said last time and this time I will say again is that we are ahead of plan in ordering and are our growth is not just due to advanced ordering. It is a combination of good order, good order environment for us, you know, strong digitization society push, slash, maybe some of the things that we have been talking about with, you know, security first networking, China, et cetera, et cetera. So it is definitely not a double ordering worry that we have there. And the real question is, do we have more visibility? And absolutely, with the backlog that we have today, we have much greater visibility moving into the quarter than we have ever had. And have, you know, the volumes that we need to be able to drive the numbers that we need. It is more of a supply issue than it is a demand issue right now. When does that shift? Don't know. Mean maybe end of the year, but at the same time, clearly at our company, relevant issues around business transformation, I am hoping that some of the things that we have enabled and brought to market allow us to actually then drive faster growth top line, because the supply chain allows us to utilize what we have in backlog accordingly and a number of the new products that we have brought to market over the last year or two years. And what we are bringing to the market over the next year will help us to drive greater growth.

00:41:48 Johannes Ries

Great. Maybe final questions on the new products. Maybe you can update a little bit on the topic of virtualization, some modules you want to deliver on the optical space and what is the hyperscale businesses doing?

00:42:07 Brian Protiva

Okay, so, clear, from a virtualization and very important for us to talk about our software, both in our virtualizing infrastructure in 5G infrastructure, is one of our targets. NFV network function virtualization that you know quite a bit about because we have been talking about it for some time. Both moving in the right direction, a couple, three important wins in the 5G infrastructure opportunity. And those are new customer footprints for us that we hope to leverage with our entire product portfolio. Really, really important for us. From an NFV perspective, also going in the right direction. Is it going to be the mass market that we had once hoped? Not short term. It is the right solution. It is the right architecture long term. But the transformational change is taking a lot longer. We have a lot of the existing vendors pushing back against it and saying how we do it all. Here we have a server with our products, our software on our OS, et cetera. But that is not open usually. And as soon as people then realize it is not really open because they are advantage to their own software solutions, they do not want anybody else in there. You know, there are times it just does not make sense, and that is when ADVA has been starting to win deals. We need more touch points, more customers, more scale, more partners enabled in those things to drive that even farther, but definitely going in the right direction for us as an organization. So virtualization continues to be very important to us. And it is front and center, or not front and center, but it is definitely one of our key strategic pieces for our software and services strategy. So I think that was that, the double ordering we answered and the backlog issue and maybe last...

00:44:02 Johannes Ries

On the modulizations and the modules you want to bring and where you want to enter the module business for delivering optical components to others or modules. It is one part also of your strategic transformation, transformation steps you highlighted using capital markets day.

00:44:25 Brian Protiva

Understood. Thank you for clarifying. I was actually going to answer some of the new stuff we are bringing in optical systems. So, yes, from a vertical strategy, we have got a lot of irons in the fire, a bunch of new products coming, already products introduced. We are selling to complementary, let's say, companies that are not really competitors to us. But in the meantime, even some of our smaller competitors, we are selling to them, the modules. We have got a lot of good, good, differentiated products coming and we are looking at going further verticalizing even in the module stuff, you know, owning the pieces that are the components that are used to build the modules. And remember the modules, we see them as actually kind of like systems technology, integrated systems technology. Using our networking knowledge to build modules/solutions for our customers that are highly differentiated because we are using our skills both from an optical skill set, but also with all our networking knowledge that we have today. And it is moving forward. Our biggest issue right now is scale, getting certain components that are part of that module in volume. That is our biggest challenge right now. But we are looking at that closely and so hope to solve that one as well so that we can drive much more volume. And I think the final one, you asked, Johannes, was what does that mean from a lead times and stuff? You said we are short. Yes. I mean, we want to get back to that. Less than 6 weeks to have a module. We are probably double that right now on average, just because it is a tough market out there, supply chain problem. And that is with the right forecasting. That is with working ever closer with our customers. So we are doing everything possible, and it is still a much longer cycle. I would believe, ADVA has always been one of the best in the industry at being able to supply, react and supply and address customer needs. I would think that we are still one of the best in the industry, but it has just gotten a lot worse for everybody. And that is because of the tightness on the components. I mean, we sometimes have to be buying components 52 weeks out into the future. So you guys all can imagine what kind of planning that needs in order to do that well.

00:46:52 Johannes Ries

My impression was on the hyperscaler. Any update on how you proceed there, how the market is? Is that a part of your American weakness or...?

00:47:03 Brian Protiva

So, I do not have the number in my head right now, I do not know if Uli has it. I mean, what we say is high single digits, up to 10. And it was a bit light, I believe, but I do not have that number in my head right now. But part of it was, was we are moving generational products. We won the next generation as well at our single biggest customer. We have won a few new opportunities actually in the hyperscale, but they are small. Like I have been saying we ae focused on some of these highly differentiated products, not big stuff, but won some other footprint opportunities. You know, some, let's say sync of timing. And we believe in a third hyperscaler, as an example. So, I think it is moving along. Not quite as much volume in Q2, partly, though, because it was generational shift and we are part of the supplier community for the next generation, for one of our biggest customers.

00:48:00 Johannes Ries

Okay, super, thank you.

00:48:00 Uli Dopfer

It is in the mid-single digit million, similar level like we have seen in Q1. So it is not quite as high as we had as a run rate last year. But it should come back.

00:48:16 Johannes Ries

That helps a little bit the margin because it is a more lower margin business.

00:48:21 Uli Dopfer

That is true, too.

00:48:22 Johannes Ries

OK, thanks.

00:48:28 Operator

The next question is by Tim Savageaux of Northland Capital Markets. Your line is open.

00:48:36 Tim Savageaux (Northland Capital Markets)

Yeah, I think that's me. Hi there, a couple of questions, one on the product side and one on the financial front with regard to guidance. On products, I wonder if you could discuss the initial reception of your kind of 800 gig product launch, and when you talk about big opportunities in the US for new products, is that part of that scenario or are you referring to other products and opportunities as well? That is one question. On the other hand, and you have already addressed this with gross margin in the second half, with anticipated US strength, but, your operating margin target still looks relatively conservative, given 9% plus in the first half. Are you expecting, as you get more events going and probably more travel, a pretty significant uptick in OpEx in the second half? Thanks

00:49:39 Brian Protiva

Uli, I'll do the first one, you do the financial question, and, 800 gig, it is a really nice product. I mean, we got best distance, got some nice differentiation for certain application spaces. I think we will do well with the product. We are ready to rock shortly here. We are out there baking it off on certain applications. But honestly, I was not even referring to that as the uptick in the US market. So I do believe that gives us further opportunity. But some of the other stuff that indirectly, some of the stuff that I said, we are struggling to scale right now, and we are very much focused on that. That, you know, in the verticalization piece is a very nice opportunity for us as a whole. I think the whole network and synchronization opportunity, there is some really nice opportunities for us in that space. So I was actually referring to that. But in the optical, yes, there is opportunity coming off the 800 gig, coming off our new optical layers in our next gen product architecture platform. So we have got some good, good pieces there to go after the market with as well. So…Uli.

00:50:44 Uli Dopfer

Let me talk to the take the optics question, so usually, Tim, I would agree with you that in a normal environment, we would probably see some increased cost in the second half of the year based on, you know, additional travel and so on. However, we all know that Delta variant is out there, and numbers are increasing again. So I, I do not see us, you know, going out that crazy in the second half of the year. We have a couple actually events scheduled, not virtual events, physical events with customers. But this should not increase our cost drastically. And then usually, as you know from the past, the second half of the year, we usually reverse some of the vacation accruals and so on. So I would anticipate OpEx rather go down, going down in the second half of the year. And this should help us to offset what I said earlier, potentially lower gross margin based on, you know, a different customer, original mix of our products. But again, there is so much risk out there still related to the supply, and I told you that we could see increased cost again from the supply side. So long story short, I would anticipate OpEx to be flat or rather down.

00:52:31 Operator

The next question is by Mirko Maier of LBBW.

00:52:35 Mirko Maier (LBBW)

Thanks for letting me in. I want to come back to the semiconductor question. To get it to the point, how much revenue did you lose in the quarter as a result of the shortage? And secondly, for the current quarter, could you secure all the components you need for Q3 to help save (00:52:58 unclear) let me say in a mid or even higher single digit range? And a second question will be regarding your income from capitalization of development expenses. There was an organic Q2, if I remember, right, the prediction was that it would come down somewhat in 2021. What is the reason for the increase once again in Q2? And are you sticking to your forecast of a slight decrease in the ongoing year? That's it.

00:53:33 Uli Dopfer

Brian, you want to take the first one and I take the second or...

00:53:42 Brian Protiva

Yes, I would like to get on the second one as well, because our net capitalization is going down, you guys actually, it is hurting the net. So I think that is the important number. But you will answer that. From a semiconductor perspective, I guess securing all our parts, even when you do not have a semiconductor crisis, it is an ongoing process. Do we secure all our parts going into the quarter? No, there is still work going on. We have got thousands and thousands of different parts. I mean, that is the work of our team in operations, to get that all done. So I think we have made huge progress compared to a month ago or a month and a half ago. We feel much better about Q3. Is it enough to grow high single digits, is your question, I think. And I think we have still got work to do. I cannot answer that question. What I can answer is that we should continue doing well as an organization moving forward, and we want to grow for the year, clearly in our 580, 610, depending on whether we are on the mid lower or high is naturally dependent on that semiconductor crisis and us securing all those parts. But we feel comfortable. We have got the backlog and the customer demand out there to go get the better of that number. And now it is the question of how much do we secure of that supply chain. So it is not a question that I can answer today. I would love to be able to answer that, but that would be in a non-semiconductor crisis mode, probably where I would make a very swift and clear answer to that. So, moving parts feel comfortable that we can get it done again and we want to grow. And I think we have got customers breathing down our necks that we have to grow. So, down to the growth point, we need to execute. You had a first part of that question, and that was with Q2 and what was the first part of the question? How much revenue was pushed into ... Uli, I will let you have that one and the capitalization one.

00:55:56 Uli Dopfer

So, we pushed about ... last year, with Covid, we had about 10 to 15 million that we had to move out each and every quarter and it is pretty much in that magnitude, maybe a little higher. So you get a feeling for that. So, it is a significant number. And then regarding the capitalization, so if you look at the balance sheet, the capitalized R&D went down from 98.1 to 97.5 million, which indicates that the amortization was higher than the capitalization. Yes, you are right. The income from capitalization increased from Q1 to Q2 by about... what is it… five hundred K. But on the other hand, the amortization increased as well. And so the net effect on our P&L was actually negative for us, about six hundred K. We said for the year you should assume a zero impact on the P&L, so amortization should be on similar levels like the capitalization.

00:56:51 Mirko Maier

OK. Great, thanks.

00:56:55 Brian Protiva

Imagine if we were getting helped like we used to be helped by that number.

00:57:09 Operator

There are no further question, so I hand back for closing remarks.

00:57:12 Brian Protiva

Thank you. Step by step. We got lots of work. I think we are doing our work pretty well. I think we are transforming the business. We will continue to focus. And I think we need to leverage our momentum to clearly go drive higher margins, higher profitability, mid-term. And that is something we are very focused on. Thank you for your support and all your questions. Bye-bye.

00:57:39 Operator

Ladies and gentlemen, thank you for your attendance. This court has been concluded. You may disconnect.

