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ADVA Optical Networking, Third Quarter 2021 IFRS Financial Results

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22 October 2021

PRESENTATION

00:01 Operator

Dear ladies and gentlemen, welcome to the conference call of ADVA Optical Networking for the first quarter 2021 IFRS financial results. This call is recorded. As a reminder, all participants will be in listen-only mode. After the presentation, there will be an opportunity to ask questions. If any participant has difficulties during the conference, please press the star key followed by the zero on your telephone for operator assistance. I now hand over to Mr. Steven Williams, ADVA Optical Networking Director Treasury and Investor Relations. Please go ahead, Sir.

00:39 Steven Williams

Thank you, Martin and welcome to ADVA's Q3 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, in the financial results section of the About Us/Investors 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 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 or losses calculated prior to non-cash charges are related to the stock compensation programs, and amortization and impairment of goodwill and acquisition-related intangible assets. Additionally, expenses related to M&A and 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 always, Brian will start and provide a business update. Then Uli will talk us through our Q3 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.

02:42 Brian Protiva

Thank you, Steven. Same procedure as each call: we'll start with the financial highlights by moving to Page 4, "Q3 2021." Our nine-month announcement sees us once again publishing very good business results. In the third quarter, we in general met the goals we set ourselves, and even exceeded them in some areas. Despite the ongoing crisis around the supply chain of semiconductor components, which in many ways worsened in recent months, we again sequentially increased our revenues in Q3 2021 and achieved an excellent level of EUR 151.8 million, representing a 3.5% increase year over year. I want to thank our entire team, especially our employees in purchasing, production and logistics for making this excellent result possible, despite all the challenges.

The performance EBIT margin was 8.6%. And that's also a very good level, even with dramatically increasing costs due to the supply of critical components. This is an increase of 17.7% year over year. And finally we increased our liquidity again to now EUR 100.5 million, resulting in a year-over-year net cash increase of EUR 55.6 million. This gives us a lot of financial leeway and positions us well in these unusual times.

Moving to the next slide, Page number 5, "Business Highlights." Demand for our products and solutions continues to develop well. The efforts of governments, authorities and companies worldwide to advance the digitization of ecosystems continued to drive solid demand for our networking technologies. Our order flow has been good from all regions and our order backlog is at a record level. We currently see risks for our business almost exclusively in maintaining a functioning supply chain. Recently, the material bottlenecks, especially for semiconductor products, have worsened. We carry high inventories and buffer stock and face long lead times. The uncertainty will most likely remain for some time. Just a few months ago, we assumed that the end of the third quarter of 2021 would be the preliminary peak of the crisis. But according to current assessments, we expect that the coming quarters will also be strongly influenced by the semiconductor crisis. This will demand a great deal of flexibility and creativity on our part.

On our business transformation strategy, we're making good and steady progress. As most of you know, this strategy is essentially based on the following three pillars: 1) disproportionate growth in security-relevant networks, sync and timing solutions, and edge computing, with customers outside of the classic network operator infrastructure; 2) increasing sales contributions from software and services; and 3) new markets and cost optimization through verticalization.

Our success in the research and education market, as well as the government sector, continued in the past quarter. On September 21, we announced that RedIRIS is using our network technology to create a robust, high-performance research and education network in Spain. The new nationwide infrastructure connects Spanish universities and research institutions across the country and enables teachers and scientists to share enormous amounts of data and use bandwidth-intensive applications. For our software product ensemble connector, we're expanding our marketing activities for SmartWAN functionality. SmartWAN is an innovative offering for the booming market for SD-WAN and SASE solutions. And in the area of verticalization we have made good progress in the past quarter, with the further development of our optical transmitter and receiver modules, which we will be launching on the market in the coming year. In summary, the demand side remains very solid, and while we keep fighting hard to overcome supply challenges, our order backlog remains at record levels.

Page 6, “Unprecedented Market Opportunity at the Edge.” While we are executing well on our vision and business plan, we’ve recently taken a new step in the direction of a strategic partnership. On August 30th, we announced our plans for business combination with ADTRAN, to create a global leader in scaled fiber optic communications technology for the access market. The merger combines ADTRAN’s global leadership role in residential access solutions founded at home and subscriber management with our global leadership position and solutions for business access solutions around carrier ethernet access and fiber to the building, optical access to metro solutions, data center interconnect and network synchronization. We are in the early stages of an unprecedented investment cycle and fiber optic infrastructure expansion, particularly in the US and Europe, driven by the goal of delivering high-speed connectivity to all homes and businesses, and future 5G infrastructure. This is driving massive investments and changing the landscape with a paradigm shift within a converged edge market opportunity.

Besides the obvious fact that digital transformation has been accelerated by the pandemic, the momentum is amplified by government stimulus, such as the US federal stimulus legislation and FCC’s Rural Digital Opportunity Fund, the RDOF fund. Further tailwind is coming from the ongoing shift by communication service providers to western suppliers, the continued build-out and progress of 5G deployments and an overall upgrade cycle driven by hybrid working environments. Thus, this high-speed broadband and connectivity investment cycle drives new requirements and convergence at the edge. The combination of ADVA and ADTRAN will not only create operational synergies and a larger product portfolio, but more importantly, this merger creates a market and innovation leader who can optimally address the new requirements that are emerging around the edge of the network. In doing so, the transaction creates a significant long-term value for all stakeholders in both companies, as it further enhances our ability to serve as a trusted supplier to customers around the world, with an unparalleled parallel set of solutions. Scale will help us drive an even better business model.

Page 7, “Requirements for the Converged Edge.” Let me highlight some of the key requirements that define network capabilities around the converged edge. The edge network needs to assure seamless service offerings for residential customers demanding higher quality SLAs, basically new work from home requirements, for small and medium sized enterprises demanding cloud connectivity, as well as for large corporations requiring highest bandwidth, and often with edge cloud support. In addition, there is an increasing demand for infrastructure solutions that address mobile fronthaul midhaul and backhaul capabilities to support ongoing build-out of 5g networks. All of these demands can be supported by a common architecture or platform. ADTRAN's 10G PON, mesh Wi-Fi 6 and subscriber management software solutions are important building blocks for the connected home and SMEs. ADVA's optical packet and edge compute solutions cover the complimentary application spaces and the backhauling of this traffic into the core network. Building these solutions under a common software framework is essential and an increasingly important aspect, whereby the combined company in the context of network marketing orchestration, management and service optimization can lead with technology, ease of use, and efficient service management.

Moving back into the network, first level aggregation often sits outside the environmentally controlled local exchanges and central offices, and equipment needs to be outdoor hardened. Once the data streams enter the metro, we need highly scalable edge transport and aggregation, a key area of strength for us. The combined company will offer a comprehensive product portfolio to provide homes, businesses and 5G infrastructure with scalable, secure and assured fiber optic connectivity paired with cloud managed Wi-Fi connectivity. Jointly, no competitor has our potential breadth. And, as a market and innovation leader, we can capitalize on these important investments.

And finally, Page 8, "Next Steps." I would like to outline the next steps to the proposed merger with ADTRAN. Step one, file S-4 and proxy statements, which have been filed in the US. Step two, that is followed by the filing of the offer document and listing perspective in Germany this month. The next step three will be an ADVA exchange offer acceptance period and ADTRAN shareholder vote, both of which occur in the Q4 2021 and Q1 2022 timeframes. And of course, the closing is subject to receipt of the required regulatory approvals and other customary closing conditions. And this is expected for Q2 or Q3 2022.

So in summary, before passing off to Uli for the financial segment of this presentation, I want to repeat: we are very excited by our proposed transaction, as it will build a pure play global innovation leader for existing access networks, while having all the technology needed for next gen requirements. Together we will become a company able to address the changing requirements, and more specifically be a global leader for that converged edge. The TAM will grow dramatically for our combined entity, enabling long term growth. And finally, the benefit of both revenue and cost synergies will enable us to present our shareholders with an impressive business model over the coming years. Uli, you are up.

13:58 Uli Dopfer

Thank you, Brian, and welcome also from my side. Before I start walking you through our Q3 financials, I would like to share some key messages with you. About one and a half years ago, the COVID-19 pandemic began. Most companies had to adapt to a different way of working and address a large set of unprecedented challenges. The pandemic changed the global economic environment, exposed weaknesses in the global supply, and ultimately led to one of our biggest challenges: the semiconductor crisis. Nevertheless, in this challenging environment, we grew our business by 5% during the first nine months of this year, compared to the same period of the previous year, and report today year to date revenues of EUR 445.6 million. At the same time, our pro forma EBIT grew by more than 100% and reached EUR 40.3 million, or 9% of revenues. On top of this, we are very pleased with our cash generation. We increased our cash balance by more than EUR 30 million and our net cash by more than EUR 55 million. Considering the current market environment and related challenges, I think that these are results we can be very proud of. I want to extend my sincere thank you to the outstanding work of the entire ADVA team.

Now let's move to slide 10, our "Q3 Key Financials." Revenues in Q3 2021 reached EUR 151.8 million, up by 3.5% from EUR 146.7 million in the year-ago quarter. Similar to Q2, also our Q3 revenues were heavily impacted by the semiconductor-related supply challenges. We had to defer orders with a volume of more than EUR 20 million into Q4. However, we still managed to grow both quarter over quarter and year over year. Our growth was primarily driven by the CSP segment. The silicon shortage also had a significant impact on our gross margins and increased our costs by a mid-single digit million number. However, due to increased revenues, with a favorable product and customer mix, we were able to maintain our gross profit level compared to Q3 2020.

We also continued our strict opex controls and were able to achieve a pro forma EBIT of 8.6% of revenues, up from 7.5% in the year-ago quarter. Net income reached EUR 18.5 million significantly up from EUR 6.7 million in the year-ago quarter. This is mainly attributable to a tax benefit of EUR 7.7 million. The standalone profitability of ADVA SE enables us to use past losses for activation of a deferred tax asset under IFRS. This explains the tax benefit in the P&L. Earnings per share for Q3 increased from 13 cents to 36 cents. As mentioned earlier, cash generation and deleveraging was once again outstanding, and we increased net cash by EUR 55 million compared to Q3 2020 and reached EUR 20.6 million net cash. Next slide please.

As explained in the past, we added this slide for the purpose of transparency and to provide our analysts and investors an enhanced comparison, since most of our peers report their numbers in US GAAP. Please note that the US GAAP numbers here have not been audited. The main difference between the two standards are due to the capitalization and amortization of R&D under IFRS. The R&D amortization leads to higher costs and for Q3, the resulting difference in gross margin is exactly seven percentage points. The R&D capitalization on the other hand, leads to lower R&D opex. Since in Q3 amortization and capitalization were on a similar level, there was no impact on the pro forma EBIT. Both standards show a pro forma EBIT of 8.6%.

Let's move to the next slide, “Regional Revenue Development Q3 2021.” EMEA revenues increased by 11% year over year, now representing 58.1% of revenues in Q3. We experienced growth across all customer groups in this region. Q3 in the Americas rebounded as expected and is sequentially up by 6 million. However, it is still EUR 4 million below the strong Q3 of 2020. The Americas represents 31.8% of our Q3 revenues. Compared to the year-ago quarter, Asia-Pacific increased by 3.9%, and now represents 10.1% of our Q3 revenues. Growth in that region was predominantly driven by CSPs.

Moving to the next slide, “Cash Flow and Balance Sheet KPIs.” We achieved a free cash flow of EUR 13.3 million, compared to EUR 11.2 million in Q3 2020. This is mainly explained by higher EBITDA levels. We are very pleased with our cash flow generation and our cash balance at quarter-end reached EUR 100.5 million up, by around EUR 32 million year over year. With our high cash balance, we are very well prepared to face the challenges resulting from supply constraints and, on the other hand, it allows us to evaluate attractive options to deploy our capital. With a debt leverage ratio of 0.5 times EBITDA, and an equity ratio of 56.7%, we have a very solid capital structure and further solidified our investment-grade credit metrics. Q3 2021 year to date ROCE was 11.9% and reflects our strong commitment to deliver shareholder value.

Next, and final slide. Despite the challenges in securing our supply due to the semiconductor crisis, we reported very good results for the third quarter, and once again proved our agility and flexibility. Our business transformation strategy, combined with strict cost control, is an essential part of transforming the business model to sustainably higher margins. Additionally, the market environment provides tailwinds to ADVA, as the network expansion continues, and the demand for our products and services across all technology areas is very high. Growing security requirements and communication networks and the importance of the country of origin in the choice of technology plays an increasingly important role for many network operators. This trend strengthens our competitive position as one of the few remaining Western specialists in optical transmission technology, with a focus on edge and metro networks, as well as a mature synchronization portfolio. As Brian mentioned, we expect that the bottlenecks in the supply of semiconductors will persist in Q4 and beyond. Hence, we still see the risk for further revenue deferrals and increased costs, which may influence Q4. Nonetheless, considering the very successful first nine months of 2021, and our strong record order backlog going into Q4, we feel comfortable with the current analyst expectations, and we confirm the revenue outlook of between EUR 580 and 610 million, with a pro forma EBIT range of 7% to 10% of revenues. With that, let's open up the Q&A. Operator, please.

Q&A

23:04 Operator

Thank you very much. Ladies and gentlemen, we are now starting the question-and-answer session. If you would like to ask a question, please press 0 and 1 on your telephone keypad. Your questions will be answered in the order as they arrive. If you're using speaker equipment today, please lift the handset before making your selection. One moment, please, for the first question. We have the first question. It's from Robert-Jan van der Horst. Your line is now open for you.

23:35 Robert-Jan van der Horst - Warburg Research

Hi ladies and gentlemen. Thanks for taking my question – two, actually. The one is an obvious one on the guidance, given the strong Q3. Despite the headwind from the supply situation, you actually managed quite a quite a good margin. So, my question was actually on the lower end expected, especially when it comes to the margin that, in my estimation, implies an adjusted EBIT margin last quarter close to zero, which means by a somewhat stable OPEX that actually the gross margin would have to drop slightly below 30%. And the question is, is that realistic? Do you really expect that the situation not only continues to be as bad as it is but actually becomes way worse in Q4? Do you see a possibility for that?

The next question is, especially on the order backlog, how reliable is that? How fast would you think that you could actually deliver those products demanded? And do you do you also experience this over-ordering of customers or maybe customers ordering simultaneously from several suppliers? So is this the real number, or do you expect that there will be some cancellations along the way? Thanks.

25:15 Brian Protiva

So I guess, Uli, you'll add to the guidance issue. I mean, the guidance is, we're just supporting our annual numbers. We feel comfortable with our business, and we have record backlog and it's a matter of execution. In no way was that a statement that our numbers are falling apart in any way or form. So for me, falling apart would be zero EBIT. I think we're solid. We're trying to move forward. We have, like I said, a record backlog. We've got a path forward to have a good Q4. The only risk is supply chain. We're working on those supply chain issues as we speak. We entered Q4 with fewer parts that are challenged – maybe some more complex issues, but more time to focus on them. So in general, the reassurance in this type of discussion internally that I had also with our team, what is the message? That's the standard way in Germany that you reconfirm your annual guidance, which makes Q4 quite wide, essentially, but that wasn't the message. The message is that we feel comfortable in our business and have one risk. Uli, did you want to add anything?

26:32 Uli Dopfer

Yeah, I would just add this one sentence: that was actually I try to say on my last slide of the presentation, is that we feel very comfortable with the market expectations right now. Having said this, you know we ship in the last week of the quarter and this quarter will be shorter again, because it's Q4 and so holidays and what have you, but we will ship several millions. And it comes down to the last day, if there are some late shipments, late arrivals, what have you, it's a challenge every year, every quarter. And we can just not be 100% sure what's going to happen. As Brian said, we have probably less critical components this quarter, but still, there's a lot of revenue tied to the critical components. And it's just too early to commit to a different strategy other than sticking to our yearly guidance. But your math was right, and we did the same math and looked into it. But again, we are very positive with our business, with everything, and also with the team, how we managed through a difficult Q3. And I think we will be able, most likely, to do the same. And we will try our best efforts to deliver great results with our Q4.

28:00 Brian Protiva

On the second issue, I think we've been fairly transparent with that. We had said booked to bills was very strong, best backlog ever, and that we did our homework and we still felt that our booked to bill is over 1, even if you were to back out ordering that was beyond, let's say, our forecasting, etc. So no, we don't see customers backing out and doing any cancellation. Could our bookings rate then decrease at some point next year, if and when the crisis is done? Sure, you could have a period where then you have lower bookings for a period of time. But our confidence in our guidance and the fact that we believe that we can live up to consensus planning as well as further growth next year is based on fundamentals and not orders. There are people who are trying to secure a logistics pipeline. We are working closely with our customers also, though, to get farther reach out into the future – again, non-cancelable, but in that sense to get better planning so that we have the ability to plan better with our supply chain because we're being required to order products out up to a year or more. And therefore, again there, we don't see that as a huge red flag, but it's something we're managing. And it's a big discussion within the organization because we've had our sales organization on bookings. And of course getting that right for next year's planning is essential for our teams.

29:50 Operator

The next question is by Michael Junghans. The line is also open for you.

29:56 Michael Junghans - Commerzbank AG

Thanks for taking my questions. I have five questions, if I may. I will ask them one by one. The first is on your gross margin in Q3. So in your intros, you just mentioned that supply chain bottlenecks have worsened over the past months. However, if I recall your words right, you also referred to Q3 as being the peak quarter in terms of cost headwind. So, is this statement correct? And does this mean you have very recently implemented price increases in order to offset the mounting cost inflation? Is this based on your recent discussions with key suppliers? Or what are the reasons that you see now becoming a bit more optimistic in saying that the peak in cost headwinds is now lying behind you? This would be the first question.

30:48 Brian Protiva

I think what we had said as the message is a little bit different. We said the peak will be in Q3, most likely, from our industry contacts, our information, our feedback from suppliers, etc. We saw that now moving off to a longer crisis. It could be a one-quarter, two-quarter, three-quarter, four-quarter crisis and continued challenges. We've been in it now for nine months. And instead of now starting to get better, Q4 could be as challenging as Q3. Q1, hopefully, then a little bit better, but the crisis is extending further than anybody had originally anticipated. So that's one point.

Second point is you saw gross margins go down. Clearly, we have excessive costs in some areas. And that's everything from, cogs costs that we're dealing with, the freight, non-cogs issues across the board. And we're dealing with that and being able to manage it halfway. And I want to say halfway, we're down in our EBIT from Q2 to Q3. And clearly that is the challenges that we're facing with the silicon crisis. Now, in general, I think we're managing them. Well, I do believe that it will impact Q4. You see gross margin as declining quite a few percentage points off of Q2. I would say that's probably now more like the area of gross margin that we will be hitting unless, of course, the crisis starts to lighten up and we have lower freight costs, we have lower expedite costs, we have less buying in gray markets, or from third-party distributors, etc., etc. So I think we're managing it. It's not good. It's huge extra cost. It's burning cash more than it should be, but that's the reality of our world. ADVA is very flexible, focused, great IT, very transparent, good planning and stuff. I think we have good relationships with our suppliers. We're very open and transparent with them have been for the last decade. And therefore I think we're doing the best we can in that environment. But again, it is an environment that's going to last for one, two, three more quarters. And I hope that ADVA's skills will get us through it without being impacted in a big way.

33:22 Michael Junghans

Thank you, very helpful. Thank you on that. My next question is on your revenue performance in EMEA. Could you please give us a bit more color here on your demand situation in EMEA, since revenue in this region was sequentially down by around 10% versus Q2? So was this decline just due to the lumpiness of the business? Or was it driven by supply constraints holding you back on the execution side? Or are we missing anything else here? I'm asking this particularly because some of your peers have already reported on Q3, and they had sequential upticks in growth across the EMEA region, so any bit of color here how EMEA might be doing in Q4 would be helpful.

34:10 Brian Protiva

Uli, do you want me to grab that? Or do you want to take that? I'll start maybe and then you can add color? I don't think we're missing anything. I do believe that there's a combination of, yes, supply chain. Also summer months in Europe are usually more impacted. So it's a time where usually or often it can be a little bit more impacted than other regions. But I do believe from a bookings world, it's still nicely strong and supported. I don't see us losing share at all in Europe, if that's the question. And we hope that that returns to prior strengths going forward. So I don't see anything that is specific to us as a company, but more around probably supply, customer-relevant short-term issues and – what do you call it? – seasonal influences.

35:10 Uli Dopfer

Let me add. I said earlier during my presentation that we had to postpone or defer about EUR 20 million in orders that were originally scheduled in Q3 into Q4. A big portion of these EUR 20 million was actually European or EMEA region orders. So if we would have been able to deliver all those orders in Q3, our EMEA numbers would have once again increased sequentially. So, no demand issue, nothing. It's just pure execution. And basically everything is tied to the semiconductor issues and supply issues. And we have to balance this out. Customers in all regions demand similar products, and we just have to balance this out. We don't want to upset customers. We work closely with our customers and try to manage the situation as good as we can. This quarter has resulted in a slide down in Europe. But again, it's just pure execution; it's nothing to do with demand.

36:08 Michael Junghans

Yes, good. Very helpful on this. Thank you. And the next question is on some of the items within the income statement. So we had some tailwind on the line of that income. As your marketing expenses were 6% below the level of Q2, could you provide a little bit of guidance here, where do you expect your marketing budget to be for Q4? And the same question goes to your net foreign currency result in your income tax results, which came out in sharp contrast to previous quarters of this year. So, I would greatly appreciate it if you could give us some kind of a soft Q4 guidance regarding these three items.

36:50 Uli Dopfer

So, selling and marketing was down quarter over quarter. It has, of course to do that-- I think we explaine that every year that in the first half of the year, we have to build up vacation reserves. And then in the second half, usually people start to take more vacation. So we get into this phase where we release vacation reserves. This is across the board, all areas. It's not only selling and marketing. It's also R&D, and also a G&A, of course. A lot of the down, to be honest, has also simply to do that some of the events that we originally planned that would happen in marketing events in the second half of the year still didn't happen or happened in a virtual manner. So for going forward, I would just assume Q4 being on a similar level as Q3 when it comes to selling and marketing expenses. And maybe other areas should be slightly down overall.

So I had actually only two. The question to the net income to the tax, I guess, was one. So, let's put it this way. During the last earnings call, we said assume in your models a tax rate of about 7%. After consulting our advisors, and back and forth, we basically had no other chance then do what we had to do. We had to capitalize some of our NOLs. And so, leading to the huge tax credit in Q3, we assume another tax credit in Q4, which will be much smaller, but still a couple of million maybe tax credit in Q4. The situation should normalize going into next year. We should, next year, get back to a normalized tax level of probably a low double-digit percentage. That’s roughly what we currently assume. So what's the what was the third one? I'm sorry? I missed that one.

38:56 Michael Junghans

Yeah, no worries. The third one was on your net currency result. This also came up positive in Q3. So any kind of volatility here? What is the assumption here for Q4?

39:13 Uli Dopfer

Usually, for our internal models, we use a neutral currency result. And as you can see, it's volatile. It just depends on how the pound and how the US dollar develops. We have a very conservative hedging strategy, so we try to hedge our cash flows and balance the risk. Again, if you do your model, I mean, it depends on what you assume. If you assume that the US dollar gets stronger, we should see another benefit in that line. If you believe the US dollar and the pound will remain flat, then there will be a zero. So it's tough to judge. If the US dollar or the pound move by a cent, it’s not that critical. If it would move by more than five cents, it would make a huge difference. But I would not focus too much on this right now, especially since nobody can really tell how it develops. It's just tough. We usually have a conservative approach when it comes to those things, and we will continue to do so.

40:20 Michael Junghans

Thank you. My last question is on your announced systems combination with ADTRAN. So it's no secret that investors in ADTRAN were somewhat surprised when the business combination was announced, as you can see in your share price performance. So, as you're looking forward to the merger announcement, what do you want to tell the investors? Why would it be appealing to create a bigger entity from your standpoint? Or in other words, where do you see the real synergies which cannot be created by standing independent?

40:50 Brian Protiva

So, again, a couple of my slides were supporting why this is essential. It's that market cycle, innovation cycle and financial market cycle, we believe, are all aligned to drive dramatic upside for a combined organization. Our complementary product range really positions us for this converged edge. We have a view of the access markets growing together and using our mutual capabilities to build end-to-end access capability to go after the residential, the business services, as well as 5G over an optical backhauling infrastructure. So it's the technology piece. And ultimately, we believe the combined organization has both revenue and cost synergies that allow us to drive a model that is highly profitable, high cash generation. And that just makes sense, because you don't need two of everything. It's not a complex cost synergy model that we've looked at. And the revenue synergies haven't even been officially planned, but I know there are many of those out there because their customers will want to buy our products, and our customers will want to buy their products, especially in the tier two and tier three in our respective regions, where we're strongest. So there's huge upside there. But fundamentally, what I see – and this I'll speak as one of the largest investors in ADVA through my share, and also the Egora share that I do have as a shareholder there – is that I believe that this company becomes a global leader in a market space that is expanding rapidly, and has huge opportunity over the next two, three, four, five years, where we could go get multiples of revenue, if we are successful in our vision.

So for the shareholders, it's not about a 1%, 2%, 5%, 10% move, or a 20% move even, because the upside is much, much greater if we're able to combine these companies, do it to plan, and then be that innovation leader in a very large market space. And we're going to go out to our shareholders on both sides, again, to help them understand just what that TAM is, and how much growth we could realize by positioning ourselves as the challenger and the innovator with almost a quarter billion dollars of R&D to invest and differentiate the company. It's just a really good, complementary, very good strategic move, which I've been looking for the last 15 years, 20 years, knowing that size does help in our market space. I think this is really best for shareholders, employees, and our customers, all of them, as constituents.

44:18 Operator

Our next question is by Geoffroy Le Guyader. The line is now open for you.

44:26 Geoffroy Le Guyader - Kepler Cheuvreux

Hi, gentlemen. I hope you can hear me relatively well. I had a specific question regarding the merger with ADTRAN. And hope you could give a bit of more granularity about this, so coming back to the questions you just answered. Your share price right now is trading below the value before the announcement of the merger. And I have a three-part question about it. The first one is, how confident are you that the 70% minimum acceptance conditions attached to the deal will be reached? And what sort of feedback so far you have been getting from your own shareholders? Do they support the transaction? And finally, can you give us some color on the material adverse change clauses attached to the merger agreements?

45:15 Brian Protiva

I will start with the first one and then maybe, Uli, you can follow up on the MAC, if we're going to comment on that. I guess my experience is that many of our shareholders understand our model very well, and they understand the combined model very well. And when I walk them through the opportunity, I read an extreme level of confidence. And the biggest issue is, can they hold the share or not? Some of the funds in Germany can't hold foreign shares. And even though we're trading on the Frankfurt exchange, they might not be the hold it. But all that can, and that's most of them, they seem quite excited in general. So I guess I feel comfortable that we have a very good chance of pulling this thing together, because the transaction makes a huge amount of sense, as already indicated in my last answer, but again, that's now a soft answer. You can't get a quantitative answer to your question at this point in time, because in addition, when you're not sure if a customer or an investor is telling you exactly what how they feel, but my personal experience so far has been very positive with our investor base. That's my personal experience when out there talking to them.

The second part of it is, I guess, the details on the contract positioning. I don't know, Uli, is that something we want to engage in on this financial call?

47:00 Uli Dopfer

I would say we don't necessarily want to engage there. There is, of course, a MAC clause in the contract, but we are by far not there yet. So I don't even want to discuss this at this point. And I think, as Brian said, we probably all are a little bit surprised where our share price is right now, how it developed. However, we know from many of our investors we have spoken to that they have increased their share since the announcement, some of them significantly. We also have some new investors. And as Brian said, we had some investors who had to get out of the share because they're not allowed to trade foreign shares. So I think everything is open. I guess we continue to see how it develops.

47:52 Operator

The next question is by Simon Scholes. The line is now also open for you.

47:58 Simon Scholes - First Berlin

Yes, hello. Thanks for taking my questions. I've just got two. In past calls, you've commented on how Software and Services has been developing as a percentage of sales. I was wondering if you could do that again. And could you also confirm that this figure or the development of this figure is related to how your EMEA business is going, or not? And thirdly, would I be right in thinking-- It sounds as if you're going to get sequential growth in EMEA in Q4. Are you also likely to see sequential growth in the other two regions in Q4, so you’re beginning sequential growth in all three markets in Q4? Is that a fair assumption? That's it.

48:50 Brian Protiva

Software and Services is at 30% of revenues. We wanted three years, so that was about half year or less, nine months ago, we started that. We'd said it had accelerated quite nicely in Q2, but that was an anomaly. That wasn't something that we expected, such a quick acceleration. We said we would hopefully try to get up to 25% at the end of the year, and that being more like 14% in services and 11% in software. I think in Q3 we're a little bit less in software than our goal, but moving forward positively in a number of application spaces. Services is pretty much in line. And we feel comfortable with that, the model of driving that to 30% of revenue, based on specifically two applications that we see in the future as the most growth for us. And that is the universal CPE application, some of the SD-WAN stuff that we just introduced, as well as what we call the DCSG, the cell-site gateway opportunity in the 5G environment where we've won a couple of footprints. And we believe we will scale that over the next couple of years, two and a half years, to drive percentages of global revenue from those products, so that we can get into a maybe 15% plus software model in that third year. So I think everything's moving along. That's not relevant to the regional discussion at all.

50:53 Simon Scholes

So you're just as strong in software and services in North America, or in the Americas, as you are in Europe, then.

50:40 Brian Protiva

Yeah, I think it's fairly well balanced, but I think verticalization might be a little bit stronger in the US market opportunity than in Europe. But I think Software and Services is pretty well distributed, the opportunities. You might have regions in any given quarter where there's some push because of a big project or something, but that's not inherent to the markets. As an example, the DCSG applications we won, we won one in the Americas and one in Europe, over the last three months or the last, whatever, four months, when we won them. So I think that's not a not a relevant issue.

And I think the second question was expectations for regional growth. Our intent is to grow the regions based on good bookings in all regions, but I can't commit to a linear play there because, as you saw in Q3, there were large relevant issues, like the supply chain and/or specific customer events, and/or the allocation discussions that can actually push things there. So that's a hard one for us to commit to.

52:05 Uli Dopfer

I would just say, Brian, that our current order backlog supports significant growth in all three regions. And it just comes back down to what we experienced in Q3, the execution and how it ties back to the semiconductor crisis and to supply chain. But the sheer order volume supports significant growth in all three regions. I guess this is the key message here.

52:33 Operator

As a reminder, please press 0 and 1 on your telephone keypad, if you would like to ask a question. The next question is by Michael Junghans. The line is now open for you.

52:51 Michael Junghans - Commerzbank AG

Yes, hello, I have just one last follow-up question on the computer on the announced combination with ADTRAN. So, from your perspective, where do you see the challenges, if any, when it comes to the post-merger integration phase, other than having two different ERP systems in place?

53:13 Brian Protiva

That starts with, clearly, the entire IT landscape and process landscape. Those are the two difficult ones. I think that we've come to agreement. We have a very clear plan, and we have very scalable systems. SAP is at the heart of ADVA, Salesforce – very scalable systems, all automated from product development, through customer offering to ordering through to production. All we have CPQ running. We have excellent systems, as does ADTRAN, but I think we've come to terms on how we're going to scale the organization. And that's the most challenging. I feel really comfortable about that being able to scale very quickly. So we have always had global processes. So even that, scaling into different regions, doesn't hurt at all. And therefore, I believe that that whole IT landscape and process landscape is going to be run extremely well by Tom and the team. And there's a clear decision on what we're going to do. And that rolls into the synergy discussion as well, exactly how we're going to make decisions rapidly, save money by making them, but have a massively scalable IT and process landscape. So that's point one.

Point two is, I think quick decisions for where we do have overlap. And I think those details have been thought through by Tom and the team, to details. So I think they have a good understanding of what they're going to do and how they're going to do it, and not hang on and just kind of have two separate businesses forever and ever. I think the real issue, though, that we're going to face is not the execution on integration. I think that will be smooth and very successful. But clearly the patience of waiting to how we combine, when we combine after getting through the different steps that we need to go through of closing this transaction, and then bringing the organizations together. And I think that's where we need to have patience. But each company on its own is successful, has platforms to continue business, grow business. As you heard, ADTRAN, they booked 1.3 book to bill this year, 1.4 in Q4 – wonderful data. And we'll be pursuing standard business as it goes until we're ready to be able to bring the businesses together efficiently, and then it will be a fairly fast 12-month process to bring those together. And remembering that the products are very complimentary, we're committing to roadmaps on both sides. And the one area that's going to be interesting, and I think that's the market situation management and optimization software platforms. So that will be the vision that we will map and run over multi-year, bringing all customers together. So I think, you guys, that's why this is such an interesting opportunity. This is not a killing products, killing a bunch of people, (laughing) not killing a bunch of people but reducing a bunch of people, and all those pieces. It's a much clearer path to integration. And again, I think it's more about patience to get and conclude on the deal and all the pieces around the deal. And then on day one we start, and we're going to run that very quickly over a 12-month period of time.

56:37 Uli Dopfer

And I guess this was one of the key statements that Brian made: we've worked together with the ADTRAN people now during due diligence and in many other meetings where we've had to file together certain documents. So, the teams work very closely together. And there is no resistance that many experience when there's an acquisition or a merger. People work together, like they would work together for the last 10 years. So it was really positive momentum on both sides. The employees of both companies support the deal. And I guess this is a huge tailwind and a huge benefit that comes with the deal. As Brian said, there will be no blood there when it comes to synergies and killing of major sites, or whatever. It's a true merger, and I guess people feel it, support it. And I think I'm not afraid of the integration and post-closing, not at all.

57:43 Operator

We have no further question for the moment. And so I hand back to Brian.

57:57 Uli Dopfer

Brian, I don't know if you're trying to say something, but you might be on mute.

58:06 Brian Protiva

So it's now two minutes to the hour. There was no more questions, correct? So I think we will be signing off. I'd like to thank everybody for attending. Great interest and many, many questions. Thank you for that. I hope we are able to clarify some of those questions well. And another step forward for ADVA as a company, and we're looking forward to being able to enter and complete the transaction for ADTRAN to build a global leader. Thank you. Talk to you soon. Bye-bye.

58:29 Uli Dopfer

Bye-bye.

58:30 Operator

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