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ADVA Optical Networking, First Quarter 2022 IFRS Financial Results

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PRESENTATION

00:02 Operator

Dear ladies and gentlemen, welcome to the conference call of ADVA Optical Networking for the first-quarter 2022 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. If any participants have difficulty hearing the conference, please press * followed by a 0 on your telephone for operator assistance. And now I hand you over to Mr. Steven Williams, ADVA Optical Networking Director of Treasury and Investor Relations. Please go ahead, Sir.

00:35 Steven Williams

Thank you, Lucas, and welcome to ADVA's Q1 2022 financial results conference call. In addition to this call, in the press release, we have posted the 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 believe, anticipate, and expect 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 2021.

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 EBIT was calculated prior to non-cash charges 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 usual, Brian will start this call providing a business update. Then, Uli will guide us through our Q1 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.

02:38 Brian Protiva

Thank you, Steven. Let's move to Page 4, Q1 2022 financial highlights. Growth is our main message this quarter. And in general, we started 2022 strong. Despite ongoing challenges due to the COVID-19 pandemic, the semiconductor crisis, and supply chain bottlenecks, we delivered more products than expected and we satisfied much of our customers' demand that is driving our growth. We met most of our targets and even exceeded them in many areas, although I personally would have hoped for less increases in semiconductor costs.

More specifically, thanks to continued strong customer demand and great efforts in purchasing, manufacturing, and logistics, we were able to expand our revenues and achieve a successful start to this fiscal year 2022. Q1 revenues were up 18% compared to the year-ago quarter, at approximately €170.5 million. Our pro forma operating income dropped to a respectable 4.6% in Q1 2022, down 39.3%, but still giving us a solid start to maintain our annual guidance range of 6% to 10%. Net cash was up by €11.4 million year on year, even though we spent aggressively to secure our supply chain and support our strategic suppliers. A secured supply chain should help us generate cash throughout the rest of the year. Most excitingly, and even with record revenues for Q1, we are starting to 2022 with a record order backlog, after setting once again record order entry in Q1 2022.

Moving to the next slide. Page 5, innovations supporting our business transformation. We have a positive macroeconomic demand environment, and the growth drivers for our industry are fully intact. In addition, as already outlined on the previous quarters, we've defined three strategic goals that will lead us to sustainably higher margins: first, increased growth in software and services; second, accelerated growth in new markets outside the traditional telco space, with a high degree of differentiation; and third, revenue growth and cost reduction through verticalization.

Our innovation engine is focused on supporting these business transformation goals. Since our last earnings call, we announced several interesting new pieces around new products and customer solutions, and I want to highlight a few. Number one, our new GNSS assurance software helps to protect third-party timing receivers from cyber-attacks. This is key, as synchronization based on satellite signal is vulnerable to failure, interference, and cyber threats. And so network operators urgently need to protect their critical timing with continuous monitoring and assurance. Two, TOYO Corporation Japan is now using our latest Oscilloquartz atomic clock to enable researchers to achieve highest positioning accuracy. R&D institutions require such new levels of precision timing for field trials and our market for high precision optical cesium technology meets the needs of verticals from telecom to critical infrastructure. Our optical cesium clock products will drive continual growth for our Oscilloquartz business unit over the coming years.

One of Germany's largest power grid operators, and point three, has successfully completed a field trial of quantum secure data transport using the ADVA FSP 3000 platform with ConnectGuard and layer 1 encryption technology. For the first time, with a full commercial solution, a future-proof key exchange based on quantum key distribution was used to encrypt data across aerial fiber cables – a very important aspect for power utilities. And point four, last but not least, in the area of verticalization, we further expand our MicroMux product family and launched the MicroMux edge BiDi module, a highly integrated multiplex solution that offers interesting added value in the rollout of 5G mobile networks, essentially allowing for four times x 10 Gig BiDi communication within one module, built specifically for 5G opportunities but can be used in various other use cases and application areas. These are only a few examples on how we are sustainably improving our cost base, expanding software and services revenue, and accessing new markets, all in the context of our open edge networking philosophy, and with a commitment to be a trusted supplier for technologies that build a trusted network infrastructure.

Page 6, innovation for the converged edge. The innovation news I highlighted on the previous slide do not only support our own business transformation strategy but are also supporting the joint vision we have with ADTRAN for the converged edge. As you all know, on 30 August 2021, we announced together with ADTRAN our intention to create a global market leader for scalable communications technologies with a focus on the so-called network edge. The business transaction combines ADTRAN's global leadership and residential fiber access, specifically fiber to the home, and local loop solutions, which you see in the middle of the slide. With our global leadership in data center interconnect, solutions for large enterprises, business connectivity – that is business Ethernet or fiber to the building – infrastructure, Metro WDM, and network synchronization. Together, we are well prepared to address new requirements, especially with regard to the convergence of the network solutions at the network edge. The combined portfolio is based on a common philosophy of open, disaggregated, and software-centric networking products that create the industry's most comprehensive solution set from the premise to the core. The merger will create significant long-term value for all stakeholders of both companies by further enhancing our ability to serve as a trusted supplier to customers worldwide, with a broader product offering. The majority of the shareholders of both companies have approved the transaction and we are currently working with the German authorities on open issues regarding foreign trade regulation. We are making progress and confident that we will obtain the necessary approvals.

And Page 7, before I hand off to Uli, the ADVA Terafactory. I want to share a piece of exciting news regarding our core facility in Meiningen. Earlier this month, we broke ground for our new Terafactory. In the photo on the upper right you see the Prime Minister of the state of Thuringia, Bodo Ramelow, with an oversized spade, with Christoph Glingener in the background, our CTO, helping us to get started with an exciting expansion project at one of our most important sites. With a total investment scope of around €12.4 million, which is partly government-funded, we're building a new state-of-the-art facility in the heart of Europe that includes R&D, new product introduction, and operations. We will use a high degree of automation. And this includes robotics, smart logistics, smart manufacturing, all supported by our own ADVA campus 5G network and lots of solar power. The combination of highly skilled employees with our planned automation investments will make us cost-competitive on a global level.

In times of deglobalization, supply bottlenecks, and higher cost of energy and transportation, we sharpened our profile as a trusted supplier with local value creation in the Western world. We are excited about the new capabilities we can drive from this facility, and we expect it to be fully operational in the second half of 2023. Uli will take us through the next slides, and we'll be back for the Q&A. Thank you very much.

12:17 Uli Dopfer

Thank you, Brian. And welcome, everybody. As Brian mentioned, revenues in Q1 reached €170.5 million, up by an excellent 18% from €144.5 million in the year-ago quarter. Similar to recent quarters, our success was limited by supply shortages. Nevertheless, today we report the highest quarterly revenue number in our history. Customer demand continues to be very strong. However, growth is becoming more and more a matter of execution. Higher purchasing costs due to the silicon shortages and the appreciation of the US dollar had a significant impact on our gross margins and increase our COGS by a substantial amount in Q1 2022. Consequently, gross profit decreased by 3.5%. Pro forma EBIT margin was a solid 4.6%, compared to 8.9% we have seen in Q1 2021. In the year-ago quarter, we had informed the capital markets that profitability was exceptionally high when compared to our historical Q1 results. Given the extremely difficult external circumstances, we are very pleased with our performance. Net income was €6.2 million, down from €11.2 million in the year-ago quarter. And consequently, diluted earnings per share were 12 cents compared to 22 cents a year ago. We have been using some of our excess cash to secure supply and still managed to improve net cash by €11.4 million year over year.

Slide 10, 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 the US GAAP numbers you see here have not been audited. The main differences 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 Q1 the resulting difference in gross margin is 6.6%. The R&D capitalization, on the other hand, leads to lower OpEx. Positive EBIT impact from R&D capitalization was 0.7%, and thus pro forma EBIT margin under IFRS was 4.6%, compared to 3.9% under US GAAP.

Slide 11, regional revenue development. EMEA was once again the strongest region. Q1 revenues increased slightly by 0.2% year over year, now representing 56.5% of revenues. Demand continues to be strong, especially from communication service providers and enterprise customers. In the Americas, Q1 revenues increases substantially by 61.3% year over year, now representing 34.7% of revenues in Q1. And it's now back to our former strength. Growth was primarily driven by communication service and internet content providers. Compared to the year-ago quarter, Asia–Pacific increased substantially by 29.3% and now represents 8.8% of Q1 revenues. Growth in Q1 was predominantly driven by strong demand for private enterprise networks in the financial services sector.

Moving to the next slide. As mentioned in the beginning, we spent some of our excess cash to secure our supply, and thus increased our inventory levels substantially when compared to the year-ago quarter. Hence, operating cash flow was negative €12.7 million. CapEx and R&D investments increased substantially, mainly due to the expansion of our production site in Meiningen and capitalized development activities, which led to a cash flow from investments of negative -€22 million, compared to negative -€12.3 million in Q1 2021. As a result, free cash flow was negative -€34.7 million, compared to a positive €15.1 million a year ago. Our debt leverage ratio of 0.5 times EBITDA and an equity ratio of 58.9% support our very solid capital structure and investment-grade credit metrics. Q1 ROCE on an LTM basis was 10% and reflects our commitment to deliver shareholder value.

Slide 13. Despite ongoing difficulties caused by the external environment, we had a good start into the 2022 financial year and showed strong execution. Demand is driven by the digitization of ecosystems and the expansion of communication networks, supported by public funding programs in many regions and countries. Our investments in innovation in recent years has laid the foundation for a differentiated portfolio of solutions, which enables us to grow. And finally, the transformation of our business towards growth markets with a higher share of software and services, as well as more verticalization, is developing well and should support our margins. Nevertheless, the entire industry is confronted with challenges arising from the global shortage of semiconductors. It's all about execution, securing supply, and the ability to deliver products while managing significantly higher purchasing costs. We currently assume that the semiconductor crisis will continue for the remainder of the year. With respect to the COVID-19 pandemic, it remains to be seen whether new lockdowns in China or other parts of the world will lead to further tightening of supply chains. We also cannot foresee if new virus variants will appear, leading to further restrictions. Considering the positive demand environment, but recognizing the supply challenges, we reiterate our full-year guidance for 2022, with annual revenues of between €650 million and €700 million euros and a pro forma EBIT margin of between 6% and 10%.

Now to Page 14. Just a brief update on the ongoing merger process with ADTRAN. The last outstanding closing condition is the FDA approval from the German government, which we still expect to receive within Q2 or Q3 this year. And with that, thank you, and I would like now to open the Q&A session.

Q&A

19:58 Operator

Thank you very much. Ladies and gentlemen, we are now opening the question-and-answer session. If you would like to ask a question, please press 01 on your telephone keypad. Your questions will then be answered in the order they are received. If you're using speaker equipment today, please lift the handset before making your selections. One moment, please, for the first question.

The first question is coming from Robert van der Horst at Warburg Research. Your line is now open.

20:28 Robert van der Horst (Warburg Research)

Hi, everyone. Congratulations on the excellent growth there. I do have a question. I read through your report, and the wording in terms of your outlook regarding the chip shortage has gotten a little less optimistic, I suppose. So, you don't really expect significant improvements now in the second half of the year, also. I would just like to have an idea, a little more detail, maybe, on how you see the situation right now and how it has developed in Q1, how it's continuing in Q2, and when you expect maybe some improvements in this area. That would be great. Thanks.

21:19 Brian Protiva

So basically, definitely we believe there's going to be challenges into 2023. And I think, if you look at the industry as a whole, that's consensus at this point. There are good signs, things like TSMC realizing more than half their revenues on 7 nanometers and above high-performance nodes, which means people are transferring designs into the latest and greatest wafer fab infrastructure, which means that reduces the stress on, let's say, the older nodes like 16-, 20-nanometer nodes, etc., that are needed for a lot of the designs that the comms community uses. And therefore, we believe things are getting better. We do believe that it's going to be a slow tail, though. We hope that we were peaking Q1/Q2 as far as costs. And you see it in our margins, this brutal impact, clearly. But like I said, we hope things slowly get better into the second half and then no longer are major challenges in 2023. That's kind of how we view it at this point.

22:39 Robert van der Horst

Thanks. Maybe a short follow-up on the top line, because in Q1 you actually reached a number significantly above the estimates. So I was just wondering if this is something you think you can keep up. Or are you expecting that, maybe, those shortages will also impede on your top line development more in the coming quarters or in the coming quarter than it did in Q1? So did you just get lucky, or is it just good procurement, and we can expect that to continue?

23:17 Brian Protiva

I believe that we are driving revenues. Margins are lower; revenues are higher. And that model, where I reiterated our 6% to 10% guidance means that we're making comments that the chip shortages, through 2023, will have impact on gross margins. And yet we're keeping our guidance, which would mean, yes, more strengthened revenues than originally planned, because of a combination of demand and our ability as an organization to actually access what's necessary to drive revenues. Part of that is, also, we've used a lot of our cash, as you see in our balance sheet, in order to secure, as I mentioned, both components as well as our supplier infrastructure to be able to respond to our increased revenue demand. And even though we had very good revenues in Q1, I also made the clear statement, I think, for those listening to my presentation, that while our backlog increased once again and we had record order entry in Q1, indicating very strong book-to-bill, the environment is such that we are now planning higher revenues with lower margins but the same framework on pro forma EBIT.

24:50 Robert van der Horst

Okay, perfect. That was very helpful. Thanks.

24:55 Operator

So the next question is coming from Hugo Paternoster at Kepler Cheuvreux. Your line is now open.

25:02 Hugo Paternoster (Kepler Cheuvreux)

Good afternoon, gentlemen. My first question is related to your top line development. As you have had strong growth in the Americas, I just wonder if you could shed some more light on that, apart from the FX impact? To what extent this performance can be replicated? And maybe, could you give us some comment from where it comes in terms of demand or customer types?

25:35 Brian Protiva

So, as some of you recall, we were a little bit defensive when people said, oh, Americas' volumes are down. And we said, for a couple of quarters, you guys, no problem. We haven't lost customers. We're strategically in a very similar position. Sometimes it's customer mix, and product mix, and just even ability to ship certain line cards that are needed. And I think what it's doing is rebalancing. So the statement is not that Americas is outgrowing the rest of the business. I think we're doing well in Europe. We're doing well in the Americas. We've continued to expand our opportunities there. We're looking at expanding our customer base aggressively with, really, our transformation strategy. And we are winning accounts there, step by step – small, even some medium-sized business opportunities. And so, in the big context of things I would view this as, I told you so, that Americas isn't weaker. We haven't lost customers. We're moving it along. We're still a strong player. We continue to win accounts in the Americas. But I'm also not making the statement that Americas is going to radically outgrow our other regions. I think it's going to continue to evolve going forward. And it is our goal to ramp it faster, with new customer wins, but we have that goal for Europe and Asia–Pacific as well.

27:10 Hugo Paternoster

Great. Thank you. And my second question is a follow-up in terms of profitability. So you maintain your pro forma EBIT margin guidance. So it implies some improvement in the second quarter. I just wonder if you could drive us through your assumption in terms of margin expansion and maybe more on the OpEx side development going in the subsequent quarter, as you already mentioned that you still expect some easing pressure on the semi shortage, which could play maybe positively from H2 on your gross margin.

27:52 Brian Protiva

Uli, do you want to grab that, or do you want me to?

27:54 Uli Dopfer

I can certainly start and then you can chime in if you have additional information. So, overall, I don't think that the cost structure will change significantly in the second quarter. As you can see, we are up in certain areas, for example, in sales; we are up in R&D, maybe across the board based on inflation tendencies we see everywhere. Gross margin, I guess at the end, there will not be a significant change. Freight costs will be up. Supply costs will be up. Expediting fees will be up, similar to what we have seen in Q1. And at the end, it comes down to the customer and product mix, what will we be able to ship. And this could have an impact on the margin profile for the second quarter. But, as Brian mentioned, we will remain in our 6% to 10% yearly guidance, which would imply that we should see probably a higher EBIT margin in the second quarter already, to get into the corridor that we are guiding.

Brian, do you want to talk about the price increases?

29:04 Brian Protiva

I would just say waiting as to increasing revenues, margins. Yes, as I've indicated, semiconductor crisis, we hope we've seen the peak now. And it's going to stay really tough in the second half as well, in Q2 and second half, but I don't believe it's getting worse. And therefore, slow recovery there. I don't think we want to name exactly percentage numbers there, but I think you'll have, hopefully, a step-by-step, incrementally linear development on that layer. And then, we are doing things to also counter lower margins. And that is, we have selectively had to increase pricings where our costs have increased dramatically for the longer time. So we've been looking at all these costs. And some of them are long-term effects; some of them are freight; some of them are short-term PPV; some of them are sourcing new sourcing channels in order just to get product at all. And we've kind of managed through that and said, what are the long-term impacts? And we're already starting to adjust pricing and to counter those mid- to long-term effects, as Uli just mentioned. But in general, I've already said this once but I'm just going to say: shifting to, maybe you could look at higher end of framework in revenues, margins coming down, but staying right in the same corridor on the 6% to 10% pro forma EBIT.

30:44 Hugo Paternoster

Okay, thanks. Thanks a lot. That was my last question.

30:50 Operator

The next questions are coming from Hana Maalej at Oddo BHF. Your line is now open.

31:08 Hana Maalej (Oddo BHF)

Hi, everyone. Thank you for this presentation. For my part, I have three questions, if I may. The first one is a follow-up on the growth in Americas. I had in mind that the backlog in there was very strong, but it was more focused on products that you couldn't really deliver, or you had difficulties to deliver. So this strong growth, apart from the Forex effect, is it more coming from the new clients that you mentioned, market share there? Or is it easing pressure on shortages regarding the backlog in the Americas?

Should I give you all the questions or--?

32:02 Brian Protiva

One by one. So, again, to go back to the Americas, when our numbers were lower, we were saying we were booking better than what our numbers were showing. We had indicated that a few times. So that's one aspect. It's a shift-back, as that was relevant to supply chain, product mix, etc. That's one issue. Second one is our customers are expanding, clearly, demand in the US. It's a good market environment, but our main, big customers were growing with that demand. Third is, yes, there is some Forex advantages that we get as the dollar is in the 1.05, 1.06, 1.07 range right now versus that 1.18, 1.19, 1.20 range. It means we are getting higher contribution out of the United States as well. So there's a number of reasons that I'm going to restate what I said. And that is that I feel there has not been a fundamental shift in our regional strengths. And the US, my guess is it's in that 30% to 38% range, 28% to 38% range. And depending on a lot of different factors, could that shift 33% to 40%? Yes, based on a very strong dollar and continued new winds. And we are winning stuff, especially with some of our business transformation products. Some of the things even are self-limited. We can't ship enough products. We'd have more volume and more margins in the United States. So the framework is solid, but there isn't a fundamental shift here, you guys. And I think that's what you guys are getting at. Is there's something in the bush where ADVA is going to grow fundamentally much faster in the United States than in Europe or in APAC? And I don't get the sense. I think both US is strong, solid, good opportunity. Second question.

34:06 Hana Maalej

Okay, thank you. Second one is about the cost structure, just to have an idea about your natural hedging. Can we have an idea about the percentage of sales labeled in dollar and the percentage in costs, just to have an idea about the hedging?

34:26 Brian Protiva

So this is our cost structure. You want actually dollar revenue contribution and how much has been converted into euros, essentially. That's what you'd like.

34:37 Hana Maalej

Yes. I mean, even in terms of costs in top line and bottom line, I would say.

34:48 Brian Protiva

So you're asking for transparency on revenues, as well as OpEx. Uli, I don't know what you want to give there.

35:00 Uli Dopfer

I can give a little bit of light to that one. So maybe, first of all, there is a negative impact to our pro forma based on the current exchange rate environment. Since we purchase more in US dollar – and I'm referring now only to the US dollar – about 80% to 90% of our cost is based on US dollar, whereas, as you can see in the slide, revenues is only 35% or maybe 40% at some point of time. So there's definitely a clear disadvantage. We also have, of course, some OpEx in US dollar. So there is a negative impact to our profitability based on the current exchange rate environment. A few million, I would say, negative impact. However, you mentioned the word hedging. You refer to natural hedging, but of course, you do some real hedging as well to offset this, which you will see then in our financial results, to mitigate that impact for the net income.

36:04 Hana Maalej

Okay, thank you. And my last question is about the Terafactory. How is it going to contribute in adverse figures? I mean, you said that it was going to be operational in H2 2023. But when do you expect first revenues? And how will it ramp up for this activity?

36:28 Brian Protiva

Well, first of all, if we get it done in Q3, you'll see first revenues in Q3 2023. If it’s done in Q4, it would be first revenues in Q4 of 2023. This doesn't fundamentally change our model. What we're doing is rebalancing from, let's say, Asia–Pacific ops strategy to a Europe-led ops strategy, more global in nature. And this has to do with the rebalancing after the trade wars, and not only the political frameworks that we were facing, but also customers’ demands. And what we didn't want to do, clearly, is we didn’t want to increase cost. So we looked at various different models and we are bringing back a lot of operational capabilities back into Europe. We've done a lot of that work already. But then we realized, you guys, some of our high-end stuff, we can drive equivalent cost, like in APAC or in other regions, by fully automating certain things. So we've selectively picked certain products that are now being manufactured with much more manual labor, and we are automating things. So again, robotics, software capabilities, the way you build the logistics facilities, all of that's being done so that we can build product. But we're building that product today already. It's not a new product that we're launching into the Terafactory. It will be existing products, and there will be two sources of those types of products. And ultimately, maybe even 100% of certain things would be done in the Terafactory. So the answer is, revenues, hopefully, in Q3 of next year. If not, then in Q4 of next year. They will be with products that we already derive lots of revenues with today. It will be able to address low volume, very complex products. But also some of the things that we can attack will be higher volume/lower costs because of, like I said, the automation capabilities of our end-to-end planning.

38:46 Hana Maalej

Thank you very much. That was it for me. Thank you.

38:52 Operator

As a reminder, press 01 on your telephone keypad if you would like to ask a question. The next question is coming from Tim Savageaux at Northland Capital Markets. Your line is now open.

39:10 Tim Savageaux (Northland Capital Markets)

Hi. Good morning. I have a question about the overall demand environment and your revenue guidance. In particular, given the commentary around bookings and backlog, which are both very strong, I would expect that you might expect some growth in the second quarter. And I just want to try and reconcile that with your unchanged guidance for the year, just given the degree of upside in Q1. You're kind of suggesting in the middle of the range. You're going to stay around this $170 million run rate throughout the year. Again, that seems conservative relative to the bookings and backlog commentary. I imagine there are concerns around supply, and that being the variability there and forming that. But it seems like we should be biased toward the high end of the range here, at the very least. I'd love your commentary on that.

And then overall, well, I hear you on the Americas side. It seems like you're catching up to demand. There does seem to have been some degree of uptick in overall demand. And I wonder if you can describe, are we reading that properly?

And maybe, what's behind that? And if you could talk a little bit more about the overall pipeline environment on the optical side, or in particular among carrier customers?

40:41 Brian Protiva

So, Uli, do you want to do the first part?

40:45 Uli Dopfer

Why don't you just start?

40:48 Brian Protiva

Okay. So I'll start with the US again. I've already covered that quite a few times. And that is, I guess, demand is solid. I think it's hard to really understand the order run rate and long-term demand picture. Tim, I think you're looking at big picture here. I guess, this sense that you get out of the industry is, yes, demand is at a higher rate than the forecast in our product area, let's say the optical area. The forecast is fairly conservative – depending on who you listen to, 2%, 3%, 4%, 5%. But I think the sense is that, yes, the demand environment is better than that. And it's not better than that for the next quarter, but it seems to be a mid-term, at least, environment. So demand environment is good, but that's not just the US, you guys. That's general and throughout Europe, as well. And we see that it's a good environment to be doing business in. We still have to track all of this very closely, because remember, the massive backlogs and those massive orderings were coming off of the shift of securing product into the future, trying to avoid things like price increases, etc. But even with that by the side, we see a very good demand environment.

Second part of the question frameworks was, yes, shifting to the upper end. Right now, coming off of Q1, that's what we're saying, is that revenue is shifting, you're right, at 170 times. You're already in the upper-- closing in, I'd say 650 to 700. So you could do a €5 million increase each quarter from where we're at, and we're still in that range area, the upper guidance. And yes, right now, as we look at our business, we're looking at our business, upper range. We're not ready to change guidance because we feel that, in general, we're still in tune with where we guided beginning of the year and feel comfortable at that 6% to 10%, which I think is the key metric anyway. But we're shifting revenue up, gross margins down, profitability solid.

43:24 Tim Savageaux

Got it. Thank you.

43:29 Operator

Next question is coming from Johannes Ries at Apus Capital GmbH. Your line is now open.

43:34 Johannes Ries (Apus Capital GmbH)

Okay, thanks because I've been cancelled several times as I tried to ask a question. I don't know why. If you only want to have certain analysts, I don't know, but maybe only because of the question I want to ask. What of your revenue increase is price increase and how much is volume? Because you want to increase your prices, I've seen. That is obviously not the case.

43:58 Brian Protiva

I think, in general, the industry has increased pricing. Different people went earlier, different people later, over the last 12 months. Some people even did two price rounds. I think, at this point, you're seeing no increase in our numbers, no price increases influencing any of our numbers up to date. The impact will start to happen in the second half of the year and fully be realized into next year from our price increases. None of the dollar demand - it is 100% real demand. But there's an underlying theme throughout the next 12 months that you'll slowly get a little bit more of these price increases because, as people reacted to price increases, ADVA was very fair to our customers and said, listen, these are the reasons, very transparent, of what's happening in semiconductor costs and supply issues. And these are long-term costs that we just can't avoid. And then we worked with our customer bases. And then some of them said, well, I don't want to accept that, and ordered long term into the future – and there's various strategies out there. So you only see, over a long period of time, some advantages off of those price increases. So, like I said, it's a step-by-step process over the next 12 months, also probably in kind of a linear fashion. And that should support both revenues and compensating some of these extra costs mid-term.

45:33 Johannes Ries

Okay, I see. So far, it's so easy to change the minds of your customers, because they have been familiar with permanent decrease in prices, not increases.

45:45 Brian Protiva

Correct. It's been a lot of work because this wasn't ADVA as a lead; it was more ADVA as a follower to an industry that just woke up one day and realized, wow, we're between a very difficult situation of service providers that are very optimized and outstanding, professional purchasing organizations pushing, pushing, pushing, pushing, and semiconductor suppliers that just didn't seem to be listening to our environments, and just increasing, increasing, increasing, increasing because they could. And I think the industry has responded and said, well, we have to, at some point, recoup some of those costs. And so different people, different companies had different strategies. But in general, the industry has moved to solidifying the pricing structure. And it seems to be in general accepted by the industry and the customer base, for most suppliers – not just ADVA, specifically, but for the industry as a whole.

46:48 Johannes Ries

I see. So, because we are in an inflationary environment, so therefore also, it’s your business in some regard. And therefore, that’s one reason – maybe you said it before; maybe I missed it – that the margins in the full year can get better, because you have this effect in the second half.

47:08 Brian Protiva

Yeah, we both have lower costs into the second half of the year. And we hope that, yes, price increases will help us into that second half of the year. And then we're working our business transformation strategy. I want to see more software and services. I want to see more non-telco business to balance our margin profiles. And then the verticalization, we're doing really well. We have some outstanding, interesting products. Our biggest issue there is scaling the product volumes. And so, we would have more time to scale some of these things. And those are the topics that we're pursuing in order to recoup margins, drive ever greater profitability, etc. So those three initiatives: business transformation; yes, pricing solidifies; and three, costs, hopefully, slightly declining linearly over the next 12 to 15 months, and hopefully, you don't see much of it left, actually, in 2023.

48:21 Johannes Ries

Okay, super. Do you see already the bandwidth which is coming from all this? Or can you indirectly see if your customers are seeing it, from all this infrastructure programs, especially in the US? You mentioned during the ADTRAN roadshows that this is a big driver. Is it something which comes in the year 2023 and later?

48:41 Brian Protiva

No, I think it's already helping. Clearly, it's helping. It's part of demand creation in various regions. That's definitely part of it. I do believe, in general, with digitization of society, bandwidth is continuing to grow nicely. And then you've got some of this five- to seven-year wave of extra government funding on top of those two initiatives so that you're in this period where all of that is helping drive, hopefully, a consistent demand development environment for our industry as a whole.

49:25 Johannes Ries

Okay. Again, the ADTRAN deal was not for reasons that you, maybe, have found more open doors in the US? You mentioned it already before that there are other reasons, yes?

49:36 Brian Protiva

Yeah. As most of you know, it’s an environment where you have a potential merger ahead of us – really, one big hurdle left – but you don't work together in any way or form. So we have not been helping each other because you just can't. There's competitive landscapes. There's legal remedies or frameworks, and ADVA’s always on everything by the book.

We are not a company to play around, and ADTRAN is the same way. So we've been doing everything very professionally, but that means we haven't been able to help each other yet. I think, if we can close the deal, there will be further very positive effects. And then most of the effects, clearly, come with the synergies and the combined organization, whether it's still two organizations or as one organization. But you start to have then more aligned and positive effects coming off of the transaction.

50:40 Johannes Ries

All right. Thanks a lot.

50:45 Operator

The next question is coming from Simon Scholes at First Berlin. Your line is now open.

50:52 Simon Scholes (First Berlin)

Hello. Thanks for taking my question. I've just got one, and that's on inventories. You were talking about investing in inventories to secure your ability to deliver. I mean, just looking at the last quarter, you've gone from €129 million at the end of December to €130 million at the end of March. The big jump looks it looks as if it happened in Q4, where you went from €100 million to €130 million. I was just wondering whether we should expect any further, larger increases in inventories during subsequent quarters this year? Well, just in general, how you see the inventory situation?

51:36 Brian Protiva

Let's answer the question because it's a little bit more complicated than that. Uli, do you want to grab it?

51:40 Uli Dopfer

I can start. You saw the big jump in Q4 already. If you compare to Q1 of last year, it's significant. It's all about the ability to deliver, right? I mean, if we continue – and I guess we indicated that we should be the same magnitude as Q1, maybe higher – to be able to deliver, then our inventory should be rather flattish on that high level that we are right now. Will there be some volatility? For sure, because, again, we are investing a lot in buying components, securing components. But I would not believe that there's a significant further uptick, unless we're really short on certain pieces where we have finished systems to the very end, and then there's only a little piece missing, and we cannot ship the system. But overall, I think this level is something you should expect throughout the year.

52:38 Brian Protiva

I'd like to add something there. So, from a cash perspective, because you're looking at inventories in cash issues, inventories grew year over year. They grew steady over the last 12 months, up only slightly now in Q1. But we are doing things like prepayments. And remember, we're growing in exposure of our contract manufacturers, and things. We are having to pay to secure infrastructure. That's why I said it very clearly in my presentation: we're paying to secure supply chain, both components and infrastructure. So some of that is coming from prepayments. That's another one that we are dealing with. And those are payments that have been rising quarter for quarter as our business is growing. We've needed to take cash in order to secure driving these higher business volumes.

53:33 Simon Scholes

Okay, thanks. That's very helpful.

53:38 Operator

There are no further questions at the moment. For closing remarks, I hand back to Brian Protiva.

53:45 Brian Protiva

Thank you very much. Being an innovation company, number one on our list is to grow, grow, grow. Environment's not bad for that. We clearly have an opportunity to manage the business even better, and that is control costs, drive up margins, execute on our business transformation. We're working hard on those things, step by step. And we will hear from each other in three months. Thank you very much.

54:18 Operator

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