ADVA Optical Networking SE

Q2 2022 Financial Results Conference Call

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Transcript

Speakers:

Steven Williams

Brian Protiva

Christoph Glingener

Uli Dopfer

Steven Williams

Welcome to ADVA's Q2 2022 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 results 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 2021. 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.

Proforma operating EBIT is calculated prior to non-cash charges related to our stock compensation programmes and amortisation 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 euros. We will target to limit this conference call to 60 minutes. Brian will start this call, providing a business update, and today our CTO, Christoph Glingener, joins this call and will provide an important technology update.

And finally, Uli will guide us through our Q2 financials, outlook and the latest progress on the ongoing business combination with ADTRAN. And finally, we will have sufficient time for questions, which we'll be happy to answer. And with that, I'll turn the call over to Brian. Please go ahead.

Brian Protiva

Thank you, Steven. We will move to page four, please, Q2 2022 financial highlights. The narrative of the past quarters continues. The digitisation and modernisation of the communication infrastructure are driving the expansion of the fibreoptic industry and infrastructure, and the demand for communication technology. This macro environment is driving an excellent order entry in all regions.

On the other hand, we continue to fight challenges in our supply chains. The current bottlenecks in procuring components and in manufacturing limit our revenue growth.

The magnitude of the cost increases for procurement, production, logistics, and warehousing, and the further clear strengthening of the US dollar, are putting pressure on our margins. Nevertheless, we are proud of the results achieved in the first six months of this financial year, and started the second half of 2022 with a record order backlog.

Q2 revenues were up 11.4% compared to the year ago quarter at €166.3 million. Six months revenues reached a record level of €336.8 million. Our proforma EBIT margin for Q2 was at 3.9%, and we report a Q2 net debt of €0.9 million in IFRS, which is equivalent to a greater than €20 million US GAAP net liquidity. We continue our aggressive approach to procuring important components and carrying higher inventory. Most excitingly, we started Q3 with further signs of solid demand.

Moving to the next slide. Page five, business transformation update. In connection with the strategic transformation of our business model, which we've been driving forward for several quarters, I can report several positive news from the second quarter. First, in the area of customer diversification and focus on new markets, we continued our journey through higher degrees of differentiation.

Numerous investments in new technologies give us access to new markets, in which we can operate in a highly differentiated and profitable manner, and grow beyond our average growth rate. Especially in the field of network security, more and more industries are interested in solutions that offer additional security against eavesdropping and cyberattacks. Several press releases about successful quantum secure data transmission and protecting networks against GNSS cyberattacks manifest our technology leadership in this area.

Secondly, in terms of revenue contributions from software and services, we are on course and launched a new offering, which has real potential. The management and orchestration, MANO, software from our ensemble portfolio is now also available as a SaaS solution, software as a service. SaaS is a particularly attractive business model for network operators who want to introduce new services quickly and cautiously, without major upfront investments.

Once again, we expanded our portfolio of software products to further drive revenue growth in this area. And the third pillar of our business transformation strategy, it's all about verticalisation. The development of new markets and cost optimisation of our own systems through stronger inhouse capabilities in the field of optoelectronics is progressing well.

In June, we announced, together with II-VI, a US based global leader in optoelectronic components, the development of a new pluggable coherent transceiver, for the efficient transmission of signals with data rates of up to 100 Gb per second.

The extremely compact and energy efficient module opens new architectural possibilities at the network edge. We expect a first prototype before the end of the year and first revenues in 2023. In the past quarter, we recognise a strong increase in revenues from our component business, resulting from modules launched in previous quarters. Overall, the verticalisation of our value chain is advancing at an exciting rate.

To give you more insights on the disruptive nature and importance of the new coherent 100G ZR module, I hand the presentation now over to Christoph Glingener, our CTO, and my successor as CEO. The official handover will take place within a very few weeks. Christoph.

Christoph Glingener

Thank you, Brian, and hello, everyone. We will go to page six, coherent 100ZR, a paradigm shift for optical edge. As you will have heard in many earnings calls, data traffic across the globe is exploding. And it's not going to slow down anytime soon. Our reliance on internet connectivity has significantly increased with the pandemic. At the same time, our expectations have also grown. We don't just expect to get online. We must have high speed, secure, and reliable connectivity.

This is forcing network operators to evolve their optical edge infrastructure by increasing transport speeds in the last mile network. In most cases, this means an upgrade from 1 Gb per second to 10 Gb per second rates. That is a ten times capacity increase which in turn requires the adoption of ten times higher speeds in optical edge aggregation devices. This has an impact on all last mile technologies.

For example, in residential broadband with DSL and fibre to the home, and market where ADTRAN has a strong play. Optical line terminals are rolled out with 100 Gb interfaces, cable operators upgrade their hybrid fibre-coax infrastructure with headend [?] supporting 100 Gb towards the network. Business Services go to 10 Gb data rates, driving 100 Gb ports as a provider edge router. And last, but not least, we forecast a rapid increase of 100 Gb ports driven by so called distributed units in 5G architecture for mobile broadband.

So, millions of aggregation devices at the optical edge must be upgraded to support 100 Gb per second rates, as well as the DWDM links interconnecting those devices with the optical network core. This can be a costly and overwhelming task for operators. The question is, what is the most efficient and economical way to do it? The answer is a new generation of optical transceivers that brings 100 Gb coherent technologies to the optical edge.

Let's move to the next slide. Page seven, coherent 100ZR, a new breed of coherent optics for the edge. Just to give you a bit of industry context, direct detect technology has been predominant in access networks. It works well and is a cost efficient solution for data rates up to 25 Gb per second. However, things become more tricky at 100 Gb per seconds, where direct detect solutions start to show distance limitations due to transmission impairments.

Coherent technology, on the other hand, is far more robust and tolerant to line impairments. This simplifies deployment and maintenance, and makes optical line system requirements much simpler. However, coherent innovation has been largely driven by hyperscale demands, maximising data throughput with higher bot rates, and more complex modulation schemes. You can see it in the bar chart that increasing the line speeds leads to an increase in port cost, but it decreases the cost per bit as we go from 100 Gb to 200 Gb, to 400 Gb, and beyond.

At the edge, 100 Gb is, for the foreseeable future, a lot of capacity. The bigger problem is power consumption. Any existing coherent solution is well above ten watts. So far, power consumption and cost levels of coherent detection have prevented its wider deployment at the optical edge, well, until now. As you may have seen in the media, we have announced a new application specific coherent pluggable device, the ADVA coherent 100ZR.

It empowers users to introduce 100 Gb coherent links in optical edge aggregation networks at lower cost and with higher operational simplicity than other solutions that are currently commercially available. The new ADVA coherent 100ZR features a new and purpose built seven nanometre DSP, codeveloped by ADVA and II-VI Incorporated. The small size and low power consumption of this DSP makes it possible to create 100 Gb coherent pluggable transceiver compliant with power dissipation of five watt.

In summary, this is a unique solution enabling a rapidly growing 100 Gb edge aggregation market. With that, I hand over Uli.

Uli Dopfer: Thank you, Christoph, and welcome, everybody. As Brian mentioned, the revenues in Q2 reached €166.3 million, up by 11.4% from 149.4 million in the year ago quarter. Q2 was the most challenging quarter in recent times. Continued slips in semiconductor delivery schedules pushed production to the back end of the quarter. And on top, we had one customer who returned already delivered products after the quarter was already over, which then triggered the ad hoc notification from July 15.

On a positive note, overall demand continued to be very strong. The issue is still that demand is growing faster than supplies. Last quarter, I said it's all about execution. And I think this will continue to be a model for a while. The already high purchasing costs driven by the silicon shortages were further impacted by the strong US dollar. Consequently, gross profit decreased by 5.1%, compared to the year ago quarter.

Proforma EBIT margin was 3.9%, compared to 9.7% we have seen in Q2 2021. Net income reached €7.3 million, down from 12 million in the year ago quarter. Consequently, diluted earnings per share were 14 cents, compared to 23 cents in Q2 2021. We continue to use excess cash to secure our supply. As a result, our net cash position of 3.9 million in Q2 2021 now turned into a net debt IFRS16 position of close to one million.

Next slide please. IFRS versus US GAAP comparison. 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 the numbers in US GAAP. Please note, the US GAAP numbers here have not been audited. The main differences between the two standards are due to the capitalisation and amortisation of R&D under IFRS.

The R&D amortisation leads to higher costs, and for Q2, the resulting difference in gross margin is 6.3 percentage points. The R&D capitalisation, on the other hand, leads to lower opex. Net impact in this quarter was negative 0.4 percentage points. Slide 11, regional revenue development Q2 2022. EMEA was, once again, the strongest region. Q2 revenues, however, slightly declined by 3.5% year-over-year, now representing 55.9% of revenues.

Demand continued to be strong across all customer groups. In the Americas, Q2 revenues increased substantially by 42.5% year-over-year, now representing 35.7% of revenues in Q2, and the Americas are now back to former strength. Growth was primarily driven by communication service and Internet content providers, in addition to the positive impact from the US dollar appreciation. Compared to the year ago quarter, Asia Pacific grew substantially by 23.2%, and now represents 8.4% of Q2 revenues. Growth in Q2 was predominantly driven by strong demand from CSPs.

Moving to the next slide. Cashflow and balance sheet. Similar to Q1, we spent a major portion of our non-operating cash to secure our supply, and thus, increase our inventory levels. Hence, operating cash flow was €6.5 million, down from 31.7 million in Q2 2021. Capex and R&D investments were negative, 12.6 million, down from negative 17.1 in the year ago quarter.

Free cash flow was negative €6.1 million, compared to positive €14.6 million in Q2 2021. Our debt leverage ratio of 0.4 times EBITDA and an equity ratio of 58% supports our very solid capital structure and investment grade credit metrics. Q2 ROCE, on a 12 month basis, was 7.7% and reflects our commitment to deliver shareholder value.

Slide 13, outlook. Our revenues in the first half of 2022 were at a record level, and our order books are very strong. Despite many external factors impacting our margins, our operating results have been solid so far. The progress of digitisation in all ecosystems, as well as security concerns in numerous industries and network operators of the western industrialised nations, are driving the demand for our technology.

On the other hand, there is still a high level of complexity with additional costs in the areas of procurement, production, and logistics. This environment will continue for the foreseeable future. Our teams work tirelessly on solutions to meet market demand, and we work closely with our customers every day to provide the best possible support for the network extension.

Against the background of a continued strong order intake, and on the other hand, a strengthening dollar in combination with persistently higher costs in our supply chains, we have decided to adjust our outlook for the full year accordingly, which we announced in an ad hoc release on July 15. We are raising our revenue guidance to between €680 and €730 million, and reducing our proforma EBIT margin guidance by one percentage point to between 5% and 9% of revenues.

The last and final slide, 14, road to business combination with ADTRAN. The last few weeks have been very eventful for our company. There has been a lot of news related to the proposed business combination with ADTRAN. Although we have provided the market with timely updates on recent developments, I would like to summarise the key milestones. Firstly, the FDI approval by the German government was the final closing condition of the business combination with ADTRAN. The closing took place on July 15.

Secondly, Brian has stepped down as CEO and moves to the board of the new holding company as Vice Chairman. From the time of the resignation, our longstanding CTO, Christoph Glingener, will assume the role of CEO. And thirdly, ADTRAN's intention to seek a nomination agreement, or a DPLTA, was the subject of another mandatory notification that we published on July 6th, 2022. With the closing, ADTRAN Holdings became ADVA's controlling shareholder.

However, both companies will continue to operate independently until a domination agreement or DPLTA becomes effective. The aim is to operationally integrate both companies, both organisations, as fast and complete as possible. Such an agreement requires the approval of other shareholders and will become effective upon entry into the commercial register.

In the past few weeks, we have taken significant steps forward to create a company with annual revenues well in excess of €1 billion, and to become one of the bigger players in our industry. There is a high investment need around the network edge, and together with ADTRAN, we will have a leading technology portfolio for this space. And with that, I'll hand over to the operator to open the Q&A.

Operator	Ladies and gentlemen, at this time we will begin the question and answer session. Anyone who wishes to ask a question may press star, followed by one, on their touchtone telephone. If you wish to remove yourself from the question queue, you may press star, followed by two. Your questions will be answered in the order they are received. If you're using speaker equipment today, please lift the handset before making your selections. Anyone who has a question may press star, followed by one, at this time. One moment for the first question, please. The first question comes from Hugo Paternoster from Kepler Chevreux. Please go ahead.
Hugo Paternoster	Good morning, everyone. Good afternoon, everyone. Can you hear me?
Steven Williams	Yes, we can.
Hugo Paternoster	Great, thank you. I have three questions, if I may. The first one is regarding the unexpected customer request to postpone the delivery that you announced for your preliminary ad hoc publication. I wonder whether you could

provide us with more information on that. The reason for this delay, if you already have an idea of the potential delivery, the timing, and potentially, also, more explanation on the profitability impact. And this is the first one.

Uli Dopfer

So, I think I take this one, Christoph and Brian. Unexpected returns, some of our customers have the right to return equipment, and since this was significant – and obviously, the quarter was closed – we felt obligated to adjust this in our numbers and go out with the ad hoc notification. And since then, this has led to us missing the consensus. And also, the deviation to the market expectations are just too high. And we want to be always open and transparent. So, I guess this was one of the of the reasons, or the main reason.

But the order will be there. So, it's not that the order got cancelled. It was just that the customer asked us, there are bottlenecks with installations, obviously, and he just asked us to delay the shipment to a later quarter. I hope that answered your question.

Hugo Paternoster

Yes. And another question regarding your profitability guidance. So, even though it seems that procurement costs have been higher than initially anticipated, along with the negative FX development, it implies profitability improvements in subsequent quarter. And I wonder if you could run us through your gross margin, and potentially, opex expectation for H2, which could give us more insight on the developments going forward.

Uli Dopfer

Sure, no problem. As I said, during my speech earlier, it's all about execution. We have we have a full orderbook that is, on the one hand, very satisfying, on the other hand, not so satisfying, because we have many customers who scream at us because we can't deliver. But we expect that we will be able to dispatch more in the second half of the year. We see signs that in certain areas, supply gets better, so we should be able to scale.

Secondly, we expect slightly improved gross margins, despite a stronger US dollar. This is simply because, I think we told you guys last time that we started to impose price increases on a broad basis, simply because we cannot swallow all the additional costs that a semiconductor shortage causes. So, we should see some impact of this price, these price increases already in Q3. Hopefully, more in Q4.

And then we also see a little bit of relief, when it comes to freight costs. So, this should, overall, help us to increase the gross profit slightly. Opex, I would assume, remains fairly

	stable, compared to the to the first half of the year, so there should not be too much movement. Of course, there will be some, but I think that's negligible. But again, it's all about execution on the top line and scale on the top line.
Hugo Paternoster	Got it, thank you. And maybe one last question regarding your revenue guidance, which has been increased. To what extent it is linked to the dollar, or potentially, volume or your own pricing at this stage? I understand that pricing may be an easily part.
Uli Dopfer	If you look to, in fact, the midpoint of our guidance, we roughly have to grow 10%, or a little bit more, compared to the first half of the of the year. I would say a small, let's say, 3% to 4% is attributable, probably to the stronger US dollar. A small portion, maybe 1%, is really the price increases, and the rest is simply the ability to execute more, to ship more, dispatch more.
Hugo Paternoster	Got it. Thank you very much.
Operator	The next question comes from Simon Scholes with First Berlin. Please go ahead.
Simon Scholes	Good afternoon. Thanks for taking my question. I notice that net R&D is at 23 million in the second quarter. I think the previous value over the last four quarters was about 20.1 million. I was just wondering if that's to do with investment in the new transceiver, and what we should expect for this item over the next few quarters. And also, with regard to the 100ZR transceiver, how big a part of your module business you expect this product to be within two or three years. Thanks very much.
Uli Dopfer	I will (definitely) take the first one. Yes, R&D is up, but this basically has to do with lower income from the capitalisation. And it's recapitalised [?] based on projects and the reaching of certain milestones in these projects. And it's just a coincidence that it fell that way. But we assume that this will continue to stay in that range. So, we believe that the R&D costs in the next quarter will be on a similar level, maybe a little lower, but similar level that we have seen in Q2. And then I don't know, Brian, if you want to jump on the next one, on the other question regarding the transceiver.
Christoph Glingener	Christoph here, I'll take it. Obviously, in our strategy to increase revenues from verticalization and forecasting 10% to 15% over some years is an important piece in it. Also, as I tried to explain earlier on the two slides, we see really a big opportunity with a big wave of upgrades of aggregation devices with this one. Hopefully, taking us higher.
Simon Scholes	Thanks very much. That's really helpful.

Operator

Again, if you'd like to ask a question, please press star, then one, at this time. Our next question comes from Robert-Jan van der Horst from Warburg Research. Please go ahead.

Robert-Jan van der Horst

Hi, everyone, thanks for taking my questions. I also have three. The first one is on the order development, which you described as pleasing. But could you give me an idea of how the order momentum developed from Q1 to Q2? Is it still stable on this almost record level that we saw during the last quarters, or is there some normalisation going on?

And my next question is on the integration. So, you just mentioned that the companies will be treated, going forward until this agreement is reached, as two separate entities. Is this affecting somehow the integration costs that you have predicted for the second half of the year? Because I still have quite some integration costs in the third quarter of about ten million. Is that still accurate or might that be postponed to the fourth quarter?

And my final question is maybe an update on the shortages. Because I've heard in the market that the number of components that are actually in short supply go down with a few critical components being very short. But apparently, especially those where you're in competition with consumer electronics, since the demand seems to be lower this year than it was last year, it's getting easier. So, could you give us maybe a picture of is there a very limited amount of critical components?

What are those components and what's your prospect for the second half of the year, especially in light of reduced demand for consumer electronics? Thanks.

Uli Dopfer

Let's talk about the order book. So, we have seen probably the strongest order intake in the first quarter of this year. It slowed down a little bit in the second quarter, but it remained on an extremely high level. And also, we expect it will remain on that level in the third quarter as well. So, we are very pleased with this development, because many of these orders are not going way into the future. So, basically what customers order, they want to have as quickly as possible, for the most part.

So, a big portion of our order book is really, for Q3, Q4, and maybe Q1 of next year. So, I think this is very satisfying and it also helps us to manage our supply chain and our suppliers. Regarding the components, I guess this is what Christoph will take. I will take the integration question. I think we knew all along that from the time when the business closes, and in case a domination agreement will be pursued, that there may be some delays in the integration.

	But I don't think this is anything that we did not expect, so I would not expect any disadvantages from this situation, because we've basically planned for it in a way. And as a matter of fact, we also planned, originally, to try to find ways without a domination agreement, if this is possible. So, nothing unexpected, no impact on costs, no slowdown in integration planning. But as we said, until a domination agreement or DPLTA is registered, the companies need to work independently from each other, and this is what we're doing.
Brian Protiva	Robert, I have a quick question. This is Brian. In your model, you put ten million of integration costs in the model. Was that understood correctly or that was not a…
Robert-Jan van der Horst	I did have some costs with the deal. It's all the costs that are somehow associated with the deal, and I think after we haven't seen a lot of them in the last quarters, I had, for the whole year, the main adjustment to the EBIT from the merger, actually, in my planning in the third quarter.
Brian Protiva	Thank you. I just wanted to clarify there, because there's not in addition integration costs coming, because the integration really starts the day of the DPLTA, where you start actually making decisions that are specific to integration. We're doing integration planning today. But there are other deal related costs. So, I think everything's good. You have everything under control. Christoph.
Christoph Glingener	On the semiconductor shortage question you had, yes, I confirm your view, it's getting a little bit fewer parts we are chasing. Although those fewer parts get more severe, so it's harder to get them, basically. So, that's exactly what we see. In terms of overall situation, it seems to get a little bit bigger on the larger node sizes. So, 40 nanometer parts, they seem to be easier to get now. Maybe pushed a little bit by consumer electronics being less in demand. But for most of our parts, we need industrial grade parts. And there, we don't see that yet. We're hoping to see a little bit of easing there, hopefully, in the next two quarters, but it is not yet there.
Robert-Jan van der Horst	Perfect. Thanks. That was very helpful.
Operator	There are no further questions at this time. I will hand back to Mr Brian Protiva for closing comments.
Brian Protiva	So, this was my last quarterly financial call, and thus, I would like to take the opportunity to thank all of you for your support for ADVA during the last 23 years, and for me personally, as the CEO and Co-Founder of the company. I'm very happy about the decision to pursue the business

combination with ADTRAN. I think we are building a global leader. In the meantime, my transitioning into the board of ADTRAN, I hope to continue to contribute in the best sense and direction of shareholder value creation.

And I'm very sure that Christoph and team are going to run ADVA perfectly for the next quarters, and hopefully, we will give them the opportunity to grow and have a very successful integration with ADTRAN. I think that's in the best interest of all of us, to go and drive global leadership, and then hopefully, in a few years, take the next strategic step. So, thank you very much. The next call, I think, will be Uli and we'll see how we bring the team together to be able to answer your questions. Thank you very much and talk to you soon.