ADVA Optical Networking

Q3 Financial Results

8 November, 2022 | 15:00 CEST

Transcript

Speakers:

Christoph Glingener

Uli Dopfer

Steven Williams

Steven Williams

Thank you, Francie, and welcome to ADVA's Q3 2022 financial results conference call. In addition to this call and the press release, we have posted a presentation, which is available from our homepage, ADVA.com, on the conference call page, in the financial results section of the about us/investor section. Before turning the call over to Christoph, 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 our 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 is calculated prior to non-cash charges related to the 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, our numbers are presented in euro. We will target to limit this conference call to 60 minutes. Christoph will start this call, providing a business update, and Uli will guide is through our Q3 financials outlook and the latest progress on the ongoing business combination with Adtran. Finally, we will have sufficient time for questions, which we'll be happy to answer. With that, I turn the call over to Christoph. Please go ahead.

Christoph Glingener

Thank you, Steven. Starting with our standard format and our business update and outlook. Page four, Q3 2022 highlights. It has been an extremely eventful third quarter and we're very proud of what we've been able to achieve. Never in our company's history have we delivered more products or generated higher revenue in a single quarter. This record quarter comes at a time when our business environment is becoming increasingly chaotic and less predictable. Supply shortages, the pandemic, inflation, the energy crisis, currency fluctuations, political tensions, etc. The list of challenges is getting longer and the speed with which we have to respond to changes is increasing. Despite this, we're proud to have delivered very strong results. Q3 revenues reached €179.6 million, up 18.3% compared to the year ago quarter at €151.8 million. Nine-month revenues reached a record level of €516.4 million. Our pro forma EBIT margin for Q3 was at a solid 6.5% of revenues and we report a Q3 cash balance of €61.4 million. We continued our aggressive approach to procuring important components and carrying higher inventory. Once again, we started the fourth quarter with a record-level backlog and further signs of solid demand.

Moving to the next slide, page five, business transformation update. In several quarters we've been updating you about the strategic transformation of our business model, which is based on three pillars. First, we are determined to further diversify our customer base and accelerate growth in private and security relevant networks. This last quarter we published a customer use case for the transport of uncompressed native video signals, using our timing expertise. We continue to innovate for these specialised applications that bring us new opportunities beyond the standard carrier infrastructure.

Secondly, we are committed to increase revenue contributions from software and services. Our momentum with network function virtualisation solutions continues to build. Bottlenecks with specific hardware components accelerate the acceptance of these aggregated models, separating the software from the underlying hardware, allowing the flexibility to deliver the identical service from a variety of hardware variants. Our universal CPE software is built to run on a wide range of servers from different manufacturers and finds more and more implementations with operators around the globe. This last quarter we announced our success with Etisalat, a joint win with our partner, NEC.

And last, but not least, the third pillar of our business transformation strategy is all about verticalization. Development of new markets and cost optimisation of our own systems through stronger in-house capabilities in the field of optoelectronics is progressing well. We launched two new solutions in the field of ultra-compact, pluggable transceivers that enable new approaches of implementing higher data rates around the edge of the network.

Next slide, page six, ADVA Network Security. Another big announcement was the launch of ADVA Network Security on October 1st. The new company was specifically created to serve the increasing requirements for secure network infrastructure. The new legal entity specialises in secure transmission technology, to protect highly sensitive communication networks from cyberattacks. The standalone company will complement ADVA's market-leading portfolio with proven and approved security mechanisms to protect wide area networks and critical infrastructure. ADVA Network Security will develop, manufacture and integrate encryption technologies into networks that can withstand increasingly sophisticated attack scenarios. The company has its own IT infrastructure with a secure data centre in Germany and will cooperate with national security authorities to ensure comprehensive protection of networks. This will also meet the most stringent requirements of organisation with highly secure needs, as sensitive data is protected even against attacks of future quantum computers. We expect this to be particularly relevant in government projects.

Onto my next and final slide, page seven, our Meiningen and Terafactory expansion. Before I close, I want to provide a brief update on our Terafactory. During our last Capital Markets Day, we announced our plans to expand our production capabilities in Germany. Deglobalisation, trade conflicts and supply bottlenecks drives the necessity to bring more elements of our value chain back in-house and closer to home. The new Terafactory is a 4,000 square meter expansion of our main manufacturing site in Meiningen. This double-digit million euro project is partially funded by the State of Thuringia and will allow us to bring the production of optical subsystems back into the heart of Europe. Higher levels of differentiation, faster response times to customer requests and greater independence of global supply chains are some of the key benefits we will gain.

Earlier this year, in May, we broke ground. The picture in the middle of the bottom row shows the ceremony with Thuringia's Prime Minister, Bodo Ramelow, and construction since then has been progressing very well. We are excited about our future in-house capabilities and expect to move into this highly automated factory environment as early as Q1 2023. With that, I hand over to Uli.

Uli Dopfer

Thank you, Christoph, and welcome, everybody. As Christoph mentioned, revenues in Q3 reached €179.6 million, up by 18.3% from €151.8 million in the year ago quarter. Q3 2022 marked a new record for revenues in a quarter and is the result of a fantastic job of our operations teams, despite the still challenging supply environment. Gross profit reached 60.9 million and increased by 16.7% compared to 52.2 million year-over-year. Despite the ongoing supply challenges and the strengthening US dollar, we maintained a gross margin of 33.9%, which is on a similar level as reported in the year ago quarter. Pro forma EBIT margin was 6.5%, compared to the 8.6% in Q3 2021. However, compared to the previous quarter, pro forma EBIT margin improved significantly by 82.3%.

Net income was €0.9 million, down from 18.5 million in the year ago quarter and this was heavily impacted by extraordinary expenses in connection with the business combination with Adtran. Consequently, diluted earnings per share were 2 cents, compared to 36 cents in Q3 2021. We continue to invest our cash in inventory and are using our credit lines to fund additional working capital. Thus, our net cash position of 20.6 million in Q3 2021 now turned into a net debt position of 17.4 million. Next slide, please.

Regional revenue development Q3 2022. EMEA was once again the strongest region. Q3 revenues increased by 11.1% year-over-year, now representing 54.5% of revenues. Demand continued to be strong across all customer groups. In the Americas, Q3 revenues performed strongly and increased by 21.5% year-over-year, now representing 22.7% of revenues in this quarter. Growth was primarily driven by communication service providers, internet content providers, in addition to the positive impact from the US dollar appreciation. Compared to the year ago quarter, Asia Pacific grew significantly by 50% and now represents 12.8% of Q3 revenues. Growth in Q3 was predominantly driven by strong demand from Australia. Moving to the next slide.

Cash flow and balance sheet. Operating cash flow was again impacted by working capital increase and was €0.6 million, down from 28.4 million in Q3 2021. We invested 17.6 million in CapEx and R&D versus 15.1 million in the year ago quarter. This results in a negative free cash flow of €17 million compared to positive €13.3 million in Q3 2021. Our debt leverage ratio of 0.7 times EBITDA and an equity ratio of 56% supports our solid capital structure and investment rate credit metrics. Q3 ROCE on a last 12 months basis was 3.5%, which is below our expectations. However, last 12 months operating income without pro forma adjustments was impacted by extraordinary costs related to the business combination with Adtran. Next slide, please.

Outlook. Our revenues in the first nine months of 2022 were at a record level and our order books are very strong. Despite many external factors impacting our margins, 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 with 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 expansion.

Nevertheless, the industry continues to solve the challenges arising from the global shortage of semiconductors. In particular,

	this includes ensuring the ability to deliver, as well as significantly higher purchasing costs. These challenges had a substantial impact on margins in the first nine months of the financial year. We continue to expect that the price level for components will remain high and that the uncertainties in the supply chain remain due to the ongoing zero COVID policy in China. On the demand side, the macroeconomic challenges due to the rising prices and interest rates are leading to greater complexity and uncertainty. However, we currently do not see any additional demand risks for the last quarter of the financial year. For the full-year 2022 we expect revenues of between 680 and 730 million and a pro forma EBIT margin of between 5 and 9%.
	Now to my final slide, road to business combination with Adtran. We communicated on July 6 that ADVA entered into negotiations regarding a DPLTA with Adtran Holdings, formerly Acorn HoldCo. The management part of ADVA and Adtran agreed on the final draft of a DPLTA on October 18. This DPLTA requires both the approval of the Extraordinary General Meeting of ADVA, which is to resolve on the approval of the agreement on November 30, 2022, as well as the registration in the commercial register. We have taken another step forward in creating a company with revenues in excess of €1 million, thus becoming one of the major players in our industry. There is a great need for innovation around the network edge and, combined with Adtran, we will create a leader in this space. With that, I would like 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. If you wish to remove yourself from the question queue, you may press star followed by two. Anyone who has a question may press star followed…
Uli Dopfer	Francie?
Operator	Yes, are you hearing me? . Anyone who wishes to ask a question may press star followed by one at this time. One moment for the first question, please. We have the first question from Robert-Jan van der Horst from Warburg Research. Please go ahead.
Robert-Jan van der Horst	Hi. Thanks for taking my question. Two, actually. The first question is on the component shortages. I've heard from other market participants that the number of components in limited supply has reduced significantly, while some critical components remain scarce. Also, that the scarcity has somehow shown first signs of improvements in the third quarter. I was just interested in a more detailed picture, how you see the shortages right now compared to the first or second quarter, if there are any significant developments that you could share.

	The second question is on the extraordinary expenses relating to the merger, they were quite high, as expected, in the third quarter. I was just interested, is that the bulk that we should expect this year or do you foresee any significant extraordinary expenses in association with the merger in the fourth quarter? Thanks.
Christoph Glingener	Christoph speaking here. I think I'll take your first question and then Uli will handle the second one. On the semiconductor shortage, yes, I would echo to what you just said. The amount of components we are chasing is getting smaller, but some of them you just can't get. So, it's getting a little bit more severe on a smaller amount of components. Nevertheless, as Uli rightly said, we do believe that we will be okay, overall in Q4. And I would also echo what you said, regarding it's easing overall. I would have to say there are still some buckets, but I think it's getting better overall, step by step. Less components, but harder to get, and then overall easing.
Robert-Jan van der Horst	Perfect, thanks.
Uli Dopfer	I'll take the second one related to the extraordinary costs. Yes, Q3 definitely was the bulk of the costs. You should see in Q4 maybe costs related to the business combination in the magnitude of not more than 1 million.
Robert-Jan van der Horst	Perfect. That was very helpful, thanks.
Operator	Ladies and gentlemen, once again, if you would like to ask a question, please press star followed by one. If you wish to remove yourself from the question queue, please press star followed by two. There seems to be no further questions at the moment and I hand back to Mr Steven Williams.
Mr Steven Williams	Okay, if there are no other questions…
Uli Dopfer	Maybe we wait a second or so.
Operator	One question just came in and that will be from Hugo Paternoster from Kepler Cheuvreux. Please go ahead with your question.
Hugo Paternoster	Good afternoon and thank you for taking my question. Just to rebound, I want to follow up on the component scarcity. You mentioned that for a few components, you have to redesign them. I just wonder, what is the cost associated with this redesigning? Is it also weighting on your margin? This is the first question. The second question is a more broad question, market wide, your view on the still strong demand on the market. Because at the moment, we are seeing some CapEx easing from the worldwide telecom operator. Just want to assess what could be the propensity for this operator to continue to spend going forward, mostly likely in 2023? Thank you very much.
Christoph Glingener	On the semiconductor shortage now, it's mostly opportunity cost

	when we're doing redesigns and getting other components. It's not necessarily a direct impact on the margin, that is more driven by component costs increasing overall, as Uli rightly said. This is mostly about not developing something nice and new and differentiated, you could do, but spending time on doing the same product again with some other components, so we can keep chipping them. I think the margins are mostly influenced in the short term by component increases and expedite fees and all those costs around it, not necessarily by R&D redesign. That's something which might hurt us, if you want to say so, in the long term because we could've done some really nice new products.
	On the second part of your question, the overall demand in the market. Broadly saying, we don't see that yet, but obviously we're also carefully looking out for what is happening in the market. So far, we see a steady demand and, as we said earlier, our backlog was even increasing.
Uli Dopfer	If I can add to this one. We still are in a situation where the demand is higher than what we are able to deliver. This might change going forward, but on the positive side, we are sitting on a large, record-order backlog, which should help us. I just read this morning that there are some expectations regarding the potential recession in Germany, the specialists predict a little bit more positive outlook than they did some weeks ago. I think hopefully we get through this on a good note.
Hugo Paternoster	Thank you very much.
Operator	Ladies and gentlemen, as a reminder, if you have a question, you may press star followed by one. Seems to be no further question and I hand back to Mr Williams
Steven Williams	Thanks, everyone, for your questions, we appreciate it. Thank you for connecting today with us. If you have any further questions, feel free to contact us at any time. Have a good day. Thank you.
Uli Dopfer	Thanks.
Christoph Glingener	Bye-bye.