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Sonus Networks, Inc. (SONS)

Q2 2017 Earnings Call

CORPORATE PARTICIPANTS

Susan M. Villare
Chief Financial Officer (Interim), Sonus Networks, Inc.

Raymond P. Dolan
President, Chief Executive Officer & Director, Sonus Networks, Inc.

OTHER PARTICIPANTS

Paul J. Silverstein
Analyst, Cowen & Co. LLC

Nick Altmann
Analyst, Northland Securities

Matt E. Galinko
Analyst, Sidoti & Co. LLC

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to the Sonus Networks Second Quarter 2017 Conference Call. During the presentation, all participants will be in a listen-only mode. Afterwards, we will conduct a question-and-answer session. [Operator Instructions] As a reminder, this conference is being recorded Thursday, August 3, 2017.

I would now like to turn the conference over to Susan Villare, Interim CFO. Please go ahead.

Susan M. Villare
Chief Financial Officer (Interim), Sonus Networks, Inc.

Good morning. Welcome to Sonus Networks' second quarter 2017 financial results conference call. Today's press release and supplementary data have been posted to our IR website at sonus.net, and submitted to the SEC. A recording of this call and the transcript will be available on our IR website shortly after the call. During our prepared remarks, we will be referring to a presentation with supporting information. Please take a moment to locate these documents on our IR website.

As shown on slide 2, please note that during this call we will be making forward-looking statements regarding such items as business strategy, our pending merger transactions, future market opportunities, and the company's financial outlook. Actual events or financial results may differ materially from these forward-looking statements and are subject to various risks and uncertainties including, without limitation, economic conditions, market acceptance of our products and services, the timing of customer purchasing decisions and revenue recognition, our agreement to effect a strategic combination with GENBAND which would result in a new combined company, difficulties leveraging market opportunities, the integration of acquired businesses, and the impact of cost containment efforts.

A discussion of these and other factors that may affect our future results is contained in our most recent Form 10-Q filed with the SEC and in today's earnings release, both of which are available on our website. Additionally, many risks and uncertainties could cause actual results to differ materially from these forward-looking statement with respect to the proposed merger with GENBAND, as well as other risks associated with the proposed merger are more fully disclosed in a joint proxy statement prospectus that is included in the registration statement on Form S-4 that was filed with the SEC in connection with the proposed merger. While we may elect to update or revise forward-looking statements at some point, we specifically disclaim any obligation to do so.

During our call, we will be referring to certain GAAP and non-GAAP financial measures. A reconciliation of the non-GAAP to comparable GAAP financial measure is included in our presentation on our website and in our press release issued today.

With that, let me turn it over to the President and Chief Executive Officer of Sonus, Mr. Ray Dolan.

Raymond P. Dolan

President, Chief Executive Officer & Director, Sonus Networks, Inc.

Thanks, Susan and welcome to everyone on the call today. I'm pleased to report that Q2 was another solid operating quarter for Sonus. We were able to get close to breakeven on a non-GAAP basis, even with seasonally low revenue in Q2 through our continued focus on driving higher gross margins and controlling operating expenses. We expect this trend of higher margins with controlled expenses to continue in the second half of 2017 and, therefore, we expect that higher second half revenue levels will drive improved profitability and cash flow.

Our book-to-bill ratio for Q2 was again above 1, and we're off to a good start for bookings in Q3. These booking trends, along with the anticipated realization of revenue from a large Tier 1 competitive displacement, provides a solid outlook for revenue, margin, and profitability for Q3. The team has done a terrific job focusing on our customers, driving innovation, and controlling our costs while at the same time preparing for an exciting combination with GENBAND, which we expect to close later this year.

Before I ask Susan to report the specifics of our performance, I'll provide an update on our project to cutover a Tier 1 VoLTE network in North America. This project remains on track and in fact we're now carrying live commercial traffic as the cutover continues. We expect this will convert to revenue in Q3 and continue to generate a long-term revenue stream for Sonus going forward.

This project is very strategic in its implications. We are displacing the incumbent SBC technology provider in the very heart of the wireless network and we're doing it with a pure software solution. As the executive sponsor for this project, I've had the opportunity to personally engage often with the customer over the past year.

Our success to date has strengthened my confidence that Sonus has made the right investments in virtualization and SDN. This project, as it goes commercial, has become an important reference for other customer opportunities around the world. Many customers face similar challenges of upgrading old architectures with vendors that simply haven't made the investment to migrate their customers smoothly to the cloud.

For example, we recently received the order to displace an incumbent supplier at a Tier 1 in Mexico. Interestingly, this deployment was based on our flagship SBC 7000. We expect this project to convert to revenue in Q4, 2017 and when completed it will likely be our largest 7K deployment to-date.

We've made similar strategic progress with a large North American cable MSO that we believe will convert to revenue in our second half of 2017 as they roll out some additional legacy capacity coupled with our 7K product.

So while we face the challenges of volatile spending patterns across the service provider customers, I'm quite pleased with our strategic progress.

At this point, I'll hand it back to Susan to discuss more details around our Q2 performance as well as our Q3 and full year outlook.

Susan M. Villare

Chief Financial Officer (Interim), Sonus Networks, Inc.

Thanks, Ray. As a reminder, gross margin, operating expense, operating income, net income and loss per share are all discussed on a non-GAAP basis and has been reconciled for you at the end of today's press release and presentation. The slides in our IR website have the details regarding our historical financial performance and our reporting framework is consistent with what we have presented in prior periods. We encourage you again to get these materials from our IR website.

Now let's move to slide 3 and take a closer look at our second quarter 2017 non-GAAP financial results.

Total revenue was $55.7 million and our non-GAAP loss per share was $0.02. Our non-GAAP operating expenses in Q2 were $39.3 million. As Ray mentioned, we delivered solid financial performance despite seasonally low quarter revenue as the team continues to do a terrific job controlling our expenses.

I would now like to move to slide 4, which is our condensed non-GAAP statement of operations. We have added our Q2 2017 actual results so you now have a ruling 10 quarters of actual non-GAAP historical information in one table.

Flipping to slide 5 is our condensed balance sheet. Cash and investments were $125.9 million at the end of Q2. Days sales outstanding were 69 days in the second quarter of 2017, which was a slight increase over Q1. We believe DSOs should decline in Q3 as we are off to a very good start with our bookings this quarter. Q2, again, marked the fourth consecutive quarter where our book-to-bill ratio was above 1. We remain debt-free as of the end of Q2 2017.

Turning now to slide 6 which is our condensed statement of cash flows. Please note that this includes cash, marketable securities, as well as short and long-term investments. In Q2 2017, cash and investments decreased by $2.9 million as compared to Q1 2017. This was primarily due to a modest increase in our accounts receivable. We used $0.8 million of cash from our operations and we did not repurchase any stock under our stock buyback program this past quarter.

Now let's turn to slide 7. I will briefly highlight a few items on our key stats. We had two 10% customers in the second quarter 2017 which were AT&T and Verizon. Revenue from our top five customers represented 41% of total revenues in our second quarter as compared to 46% in Q2 of 2016.

Product revenue from enterprise customers was strong at 25% of product revenue this past quarter. This compares to 28% in Q1 2017, and 20% in Q2 2016. Product revenue from Sonus SBC 7000 and Sonus SBC 5000 was $11.2 million in Q2. This compares to $12.9 million in Q1 and $13.6 million in Q2 2016.

Now let's look at slide 8 which summarizes our forward-looking outlook for the remainder of FY 2017. We expect our third quarter revenue to be between $70 million and $72 million. We anticipate non-GAAP earnings per share to be between $0.17 and $0.20. Looking to full year 2017, we believe total revenues for the year as compared to the prior year will be flat, although risks remain that revenue could decline slightly depending on the status of certain orders currently in play in our fourth quarter.

In particular, there's one Tier 1 service provider that is in the midst of a merger closing which could delay their orders to the first half of 2018. We will have greater clarity on our third quarter earnings call in October as it relates to Q4, once our customers solidifies their second half spend plan. Our non-GAAP earnings per share outlook remains unchanged at $0.26 for fiscal year 2017.

I'd now like to turn the call back to Ray for his closing remarks.

Raymond P. Dolan

President, Chief Executive Officer & Director, Sonus Networks, Inc.

Thanks, Susan. I'll conclude with some comments about our current standalone progress, and then I'll describe what I believe is the compelling rational for our planned merger with GENBAND.

For Sonus, our first half performance was solid and proves that we've continued to drive efficiencies through R&D investments and process improvement. I'm getting terrific feedback from our customers that we are easy to do business with and that we are increasingly strategic given our product portfolio, especially our leadership in software and SDN.

We've lowered our breakeven revenue levels further through continued gross margin improvements and cost efficiency. Still, our first half revenue was seasonally lower than our projected second half and that seasonality is likely to repeat itself in 2018. Standalone, we lack the sufficient scale to remain profitable in all four quarters given the seasonality.

The second half is starting off strong with a promising Q3 outlook, but we remain susceptible to customer spending patterns as they consider further consolidation. Growth is difficult to achieve organically when our end market customer spending is flat. Still, we are starting to see significant opportunities for competitive displacement.

Our success in 2017 is already creating more interest as we sustain our commitment to technological leadership and world-class products. Customers trust Sonus. As we approach our 20th anniversary on August 7, many of our customers know that we've been running their most critical applications at scale for nearly two decades with high quality.

So we have the basis for a very good company, but to be a great company we need more scale. This is the fundamental logic behind our planned merger with GENBAND and the benefits are compelling and straightforward. Our customers have given us strong feedback supporting the merger. Both companies are very strategic and respected by their customers, both for core products as well as potential growth with the integration of SDN security and Kandy.

The proposed combination is expected to provide large opportunities to save costs, drive significantly higher gross margins over time, improve financial return to shareholders, and reinvest in future technologies so that customers can transition smoothly to a secure cloud architecture and embed real-time communications across a broad range of APIs in a SaaS complex.

This is indeed a very exciting time for Sonus and our shareholders. The global economy is a digital economy. That digital economy is enabled by networking. And networking is increasingly moving to software with the lines between voice, video and data blurring.

The evolution to the cloud is opening an opportunity to create a completely new control plane that is secure and agile and yet robust enough to handle the complex needs of real-time communications. Our proposed merger with GENBAND brings together the people, the technology and intellectual property and the global reach through existing customers and partners to enable us to compete more effectively in that new architecture. We appreciate your support of Sonus.

And now operator, please open the line now for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] The first question comes from the line of Paul Silverstein with Cowen. Please proceed. Mr. Silverstein, your line is open, please go ahead with your question. Mr. Silverstein, please verify your mute button. We are unable to hear you at this time.

Paul J. Silverstein
Analyst, Cowen & Co. LLC
Q

Ray, my apologies. [indiscernible] (:14:47). Ray, what's the biggest opportunity, what's the biggest risk in here?

Raymond P. Dolan
President, Chief Executive Officer & Director, Sonus Networks, Inc.
A

Thanks, Paul. Biggest opportunity is short-term competitive displacement from a market point of view, probably the biggest financial opportunity is to double our EBITDA per share by driving synergies over the next 12 months as we consolidate and merge with GENBAND. By far the biggest long-term opportunity is to unify the two perimeters for voice and data at the enterprise and drive the controlled plane of the cloud.

Our biggest telco partners and our biggest enterprise customers are just loving the fundamental architecture that we've laid in place. And now with Kandy as a CPaaS platform sitting on top of that, it's a business case, the use case for driving a new cloud architecture comes to life because we start to touch the application layer. And that's when you can really talk about driving additional business opportunities for our customers, both enterprise and service providers.

So, huge short-term opportunity in competitive displacement, financial return increase, like literally doubling cash flow and EBITDA per share through the merger. And then long-term, we really now have the scale to drive the R&D intensity to control the cloud control plane. And we've had some significant wins in Tier 1s that give me confidence that we can do this as a team going forward.

Now with respect to risk, you asked risk, go ahead Paul.

Paul J. Silverstein
Analyst, Cowen & Co. LLC
Q

No, no, I'm sorry [indiscernible] (16:16).

Raymond P. Dolan
President, Chief Executive Officer & Director, Sonus Networks, Inc.

A

So with regard to risk, it's just we continue to live in a very competitive environment where our customers are under stress, frankly even the cloud guys are duking it out and the enterprise folks are spending a fortune securing their networks and struggling to figure out how to drive to both private and public cloud architectures, and the service providers are all consolidating. So we face a lumpy spend pattern.

We are diversified across the globe at Sonus and the GENBAND merger will diversify us further which I think will insulate us a little bit better from the risks. But those risks remain and we frankly think they'll remain for a very long period of time and we're going to run our business accordingly. Okay.

Paul J. Silverstein
Analyst, Cowen & Co. LLC

Q

All right. I appreciate. I'll pass it. Thank you.

Raymond P. Dolan
President, Chief Executive Officer & Director, Sonus Networks, Inc.

A

Okay. Thanks, Paul.

Operator: Thank you. The next question comes from the line of Mike Latimore with Northland Capital Markets. Please proceed.

Nick Altmann
Analyst, Northland Securities

Q

Hey, guys. Thanks for taking my questions. This is actually Nick Altmann on for Mike. Just assuming the merger closes on time, when might cost synergies be fully complete with GENBAND?

Raymond P. Dolan
President, Chief Executive Officer & Director, Sonus Networks, Inc.

A

Thanks, Nick. We expect it to close either late Q3 or early Q4, which would be my over/under right now on time. We'll have a substantial amount of the synergies done in the first quarter after that close but the full synergy forecast will probably take the balance of 12 months.

Nick Altmann
Analyst, Northland Securities

Q

Okay. Okay. And then are you guys seeing any delays around Microsoft Skype for Business deployments?

Raymond P. Dolan
President, Chief Executive Officer & Director, Sonus Networks, Inc.

A

I don't know that I would call them delays. They've always been choppy and there has been a considerable amount of flux, organizationally and strategically, in what was Lync and now Skype for Business. But I don't – I wouldn't call them delays as much as just choppiness.

Nick Altmann
Analyst, Northland Securities

Q

Okay. Got it. Thanks, guys.

Raymond P. Dolan
President, Chief Executive Officer & Director, Sonus Networks, Inc.

A

Thank you.

Susan M. Villare
Chief Financial Officer (Interim), Sonus Networks, Inc.

A

Thanks.

Operator: Thank you. [Operator Instructions] Our next question comes from the line of [ph] Steve Cohen with Provo Partners (18:36). Please proceed with your question.

Q

Ray, the merger with GENBAND, are you beginning to see any results yet from customers as far as the increased scale leading to them more likely to be doing business with you?

Raymond P. Dolan
President, Chief Executive Officer & Director, Sonus Networks, Inc.

A

Yeah. Thanks, [ph] Steve (18:56), for the question. Absolutely, in one word, absolutely. Some of our most strategic customers have placed tremendous value on both companies for both the core and growth strategy. The core, I mean, both companies run a substantial amount of voice, whether it's at the edge or in the core of some of the largest telcos around the world. And they love the fact that this strengthens us financially, allows us to reinvest some of that financial benefit back into the future. And they love the fact that we would help them integrate up the stack into Kandy which standalone is a CPaaS platform and gives them competitive response to [indiscernible] (19:34).

So I'd say yes. I'd be cautious as to how quick that ramp will build and it could be offset by a little bit of flux in the short term as small customers, like, pause for 90 days and try to figure out what to do on some small deals. But net-net, I expect this to give us a bigger addressable market and more product to sell.

And by the way, we can do that through basically the same sales force, with improved depth and breadth and still save money through our synergy.

Q

Thanks.

Raymond P. Dolan
President, Chief Executive Officer & Director, Sonus Networks, Inc.

A

Sure. Thank you, [ph] Steve (20:07).

Susan M. Villare
Chief Financial Officer (Interim), Sonus Networks, Inc.

A

Thanks, [ph] Steve (20:08).

Operator: Thank you. The next question comes from the line of Jess Lubert with Wells Fargo. Please go ahead.

Q

Hey, guys, it's [ph] Mike (20:18) on for Jess. Ray, can you talk a little about the company's security opportunity, how are your partnerships progressing with Fortinet, Palo Alto, are you developing new products to address new security applications and when should we start to see some of these initiatives start to drive material business for Sonus?

Raymond P. Dolan
President, Chief Executive Officer & Director, Sonus Networks, Inc.

A

Yeah. Thanks, [ph] Mike (20:39). So we've announced our security strategy well over a year ago by really fundamentally repositioning what we already do as an SBC, as a voice firewall. That's become obvious now to the industry after 12 months of positioning ourselves that way. They understand, we've always been starting and stopping flows in SIP and other voice and real-time related protocols. And we by the very nature of doing what we do, we secure the edge, the perimeter of the voice architecture. And we secure the interfaces frankly from the standpoint of interconnect and peering.

So we're now in software. We've been in software for all of our products for a number of years and we began establishing partnerships. You'll recall that we announced our first partnership with Palo Alto right around Mobile World Congress. They are still our principal partner. We'll go GA through them later this year.

And we announced the second partnership with Fortinet driven really by the service providers because Fortinet has a more significant share and is a more important part for some service providers in the managed service offerings that they do.

Later this year, we'll have more to say about our results. We will launch out into the marketplace our first commercial SBC as a service managed offering with one of the large Tier 1s in North America. We'll launch that in late Q3. I expect we'll start to get lead gen leading up to that and subsequent to that. It won't necessarily be a material part of our results because they'll be fairly small deals into the enterprise on a managed service basis, but it will be a significant contributor to next year. So I'm very pleased with that.

We're probably going to limit our partners at this point in time to those two so that we don't get distracted. That represents a pretty good share and then there's no reason in the world we can't enable all the rest. And the simplest way to think about it is just like a Reese's Peanut Butter Cups, your chocolate, my peanut butter, together you make a new product. Everybody's in software now. Everybody's virtualized so the next gen firewall, which knows how to deep inspect lots of packets but doesn't run at line rate, can interface nicely in a software environment with the application it runs at line speed and manages voice. And they both inform each other and you end up with a stronger product. Okay.

Q

I like your analogy. And then just you indicated the win with the North American Tier 1 that's started generating revenue in Q3 as a virtual deal. Can you just provide a sense of how big virtual is as a percent of your total business and how we should start to think about the speed at which your business transitions from hardware to software over the next few years?

Raymond P. Dolan
President, Chief Executive Officer & Director, Sonus Networks, Inc.

A

Sure. That deal we've disclosed in the past is just south of $10 million. There will be some add-ons to that that continue to happen over time. But they probably won't be substantial enough to disclose as 10% customers. But that's what has been driving that customer to be a 10% customer up till now and going forward.

The virtualized software-only revenue is becoming a bigger and bigger piece of our revenue. We recognized – we've now recognized [ph] BESO (23:55) in our software-only world and we're now able to pull through some revenue through rev-rec and it contributed to Q2. I expect it to contribute to every quarter going forward.

I don't want to size that yet, but probably when we guide next year we'll talk about how big it contributes to it, but it will be part of our continued margin progression. I expect our gross margin this year as a standalone company before we merge to be just slightly north of 70%. And I would expect that the next couple hundred basis points that we always set out as an objective per year will come from greater software contribution.

Q

Great. Thanks.

Operator: Thank you. The next question comes from the line of Matthew Galinko with Sidoti. Please go ahead.

Matt E. Galinko
Analyst, Sidoti & Co. LLC

Q

Hey, good morning. Ray, you called out the JITC certification for the software SBC. I guess I'm curious if there's pull from that market from software virtualized solution or is this sort of just anticipation of infrastructure decisions moving in that direction.

Raymond P. Dolan
President, Chief Executive Officer & Director, Sonus Networks, Inc.

A

So, Matt, I'm going to assume, unless you tell me otherwise, you're talking about in the federal space because we've had a software based SBC offer out there for a while and as I just said, we'll go live in North America with one of the managed SBC as a service offerings with a Tier 1 in third quarter. But this JITC certification has been underway for a long time and we are the first one out of the gate with a software-only solution.

This lines up really nicely going forward, presuming that we consummate our merger with GENBAND, it lines up really nicely with a lot of their product offerings that exist in the federal space, not only in the U.S. but globally. And so we've had some interest from areas like the Pentagon and other areas like this and I expect that we'll contribute to 2018 revenue nicely.

Matt E. Galinko
Analyst, Sidoti & Co. LLC

Q

Great. Thank you.

Raymond P. Dolan
President, Chief Executive Officer & Director, Sonus Networks, Inc.

A

Thank you.

Operator: Thank you. It appears at this time that there are no further questions on the phone lines.

Raymond P. Dolan
President, Chief Executive Officer & Director, Sonus Networks, Inc.

Okay, operator, thank you very much for running it. My summary to those that are on the call, thanks for your questions. For those that stepped in, we look forward to reporting more about the filing of our S-4 and the processes driving towards the successful close on our merger with GENBAND. We'll report through the balance of the year, both standalone companies and then we'll move forward as a combined company in 2018. Thanks for your participation today and have a great summer.

Operator: Thank you, ladies and gentlemen. That does conclude the conference call for today. We thank you for your participation and ask that you please disconnect your lines. Thank you and have a good day.