26-Apr-2018

Ribbon Communications, Inc. (RBBN)

Q1 2018 Earnings Call

CORPORATE PARTICIPANTS

Sara Leggat
Investor Relations Contact, Ribbon Communications, Inc.

Franklin W. Hobbs
President, Chief Executive Officer & Director, Ribbon Communications, Inc.

Daryl E. Raiford
Chief Financial Officer, Ribbon Communications, Inc.

OTHER PARTICIPANTS

Dmitry G. Netis
Analyst, William Blair & Co. LLC

Michael Latimore
Analyst, Northland Securities, Inc.

Mark Kelleher
Analyst, D. A. Davidson & Co.

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by, and welcome to the Ribbon Communications First Quarter 2018 Earnings Conference Call. During the presentation, all participants will be in a listen-only mode. Afterwards, we'll conduct a question-and answer-session. [Operator Instructions] As a reminder, this conference is being recorded on Thursday, April 26, 2018.

I would now like to turn the conference over to Sara Leggat, Head of Investor Relations. Please go ahead, ma'am.

Sara Leggat
Investor Relations Contact, Ribbon Communications, Inc.

Thanks, Sarah. Good morning and welcome to our first quarter 2018 financial results conference call. On the call with me today are Fritz Hobbs, President and CEO; and Daryl Raiford, CFO.

Today's press release and supplemental data have been posted to our IR website at ribboncommunications.com. A recording of this call and a transcript will be available on our IR website shortly after the call.

Please note that during this call, we'll be making forward-looking statements regarding items such as business strategy, 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 products and services, the timing of customer purchasing decisions, revenue recognition, our ability to successfully integrate GENBAND and Sonus, difficulties leveraging market opportunities and the impact of cost containment efforts.

A discussion of these and other factors that may affect our future results is contained in each of Ribbon Communications' latest annual, quarterly, and current report on Form 10-K, 10-Q, and 8-K and in today's earnings release, all of which are available on our website.

Additionally, many of the risks and uncertainties could cause actual results to differ materially from these forward-looking statements. 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'll be referring to certain GAAP and non-GAAP financial measures. Reconciliations of historical non-GAAP measures to comparable GAAP financial measures are included in our presentation on our website and in our earnings press releases issued today.

With that, let me turn it over to our President and Chief Executive Officer, Fritz Hobbs.

Franklin W. Hobbs

President, Chief Executive Officer & Director, Ribbon Communications, Inc.

Thank you, Sara, and good morning to everyone on the call today. First quarter was our first full quarter operating as Ribbon Communications. We're pleased with our performance including non-GAAP revenue of $135 million and adjusted EBITDA of $1 million. We quickly established rhythm as an innovative technology provider, meeting the customers' demand for secure, real-time communications. Specifically, we have brought our capabilities and solutions to the market and are leading the network modernization trend for both service providers and enterprises.

On our last call, I stated that our top priority for 2018 is to ensure that Ribbon turns in a highly efficient manner, runs in a highly efficient manner and that we capture cost synergies as part of the merger integration process. We believe that driving meaningful profitability will lead directly to increase shareholder value.

We've operationalized over $65 million in annualized cost synergies to-date, which exceeds the target we shared with you all at the time of the merger. Following our solid first quarter performance, we believe we are well-positioned to deliver against our previously provided guidance of $75 million in adjusted EBITDA for the fiscal 2018.

This morning I'd like to update you on our business integration and the other strategic priorities outlined during our last call. I will then turn the call over to Daryl, who will discuss our first quarter financial results in greater detail.

Our team has worked tirelessly to ensure that our integration efforts have been as seamless as possible for our customers and partners. We've already operationalized many of our necessary actions, and are on track with our remaining integration efforts. We are driving efficiencies and realizing synergies across our cost structure.

On the cost of goods sold front, we are optimizing our supply chain, operations, and services. In the R&D area, we are maintaining healthy levels of investment, including increased investments in growth areas, but eliminating redundancies and resources as we streamline our product offering. Finally, we're realizing meaningful synergies in our SG&A areas where we have already combined our sales organizations and we removed administrative duplication inherent in the two companies joining together.

Now, I'd like to talk about our progress towards our strategic initiatives and market opportunities that I outlined previously. Today, Ribbon has a strong market position with significant scale, a global footprint, and a large and diverse customer base. This is a great foundation on which we will continue to develop our business.

Our first initiative is to continue the investment in our core products and solutions to lead our customers into the next phase of network modernization. Our network modernization solutions allow service providers and enterprises to transition their existing legacy networks to IP-based technology. This market transition is characterized by network virtualization, which presents an attractive share opportunity for us given our virtualization leadership position.

Software virtualization has been an R&D investment priority for us. These solutions continue to gain momentum as we help service providers and enterprises respond more quickly to consumer and business demands.

Recall that, in January, we announced that Verizon selected Ribbon to power its Virtualized Session Border Controller as a Service solution for its enterprise customers. As the SBC market has evolved from hardware-based SBCs to innovative data center services, we are seeing an emerging opportunity to gain market share with SBCs from service providers. Verizon has signed up a major metropolitan city to utilize this solution. We expect this to be a growth area over time as Verizon continues to ramp its activity and as other service providers transition away from hardware-based SBC deployments.

We also continue to see traction with our enterprise and federal government communication solutions. Shortly before merging our two companies, we won a competitive bid for one of the largest Voice over IP deployments ever in the U.S. Department of Defense. At Ribbon, we have the required JITC certifications for both Unified Communications and SBC solutions, which allows us to provide a more comprehensive offer than either Sonus or GENBAND could provide standalone companies. We believe that this signature win with the U.S. Department of Defense will likely open up the door to many new opportunities with the military. Overall, I'm encouraged about the potential for our core network transformation solutions going forward.

Our second initiative is to expand into adjacent markets and related applications. Specifically, we see our cloud-based Kandy Communications Platform as a Service offering and our Ribbon Protect security offering as two meaningful growth areas for the coming years. We continue to make progress with Kandy and are pleased to report we successfully completed a proof of concept with one of our global channel partners serving a major car rental company in the United States.

They are migrating their communications at airports, car sale sites and neighborhood car rental locations to our Kandy Cloud Communications platforms. They selected Ribbon for experience and providing reliable multi-site business communication services. We expect the definitive expansion agreement to be completed in the second quarter. So far, 11 locations have been migrated their communications to Kandy and 70 more are planned in the future.

We are continually enhancing our security portfolio and are excited about the recent launch of Ribbon Protect which we announced at Mobile World Congress in February. Ribbon Protect provides end-to-end visibility threat detection and mitigation to help service providers and enterprises manage these threats to their networks.

We're extremely pleased to announce our first Ribbon Protect contract with one of our existing customers, a Tier 1 service provider based in the Asia Pacific region. This is a significant win for us as it establishes a beachhead in the security and behavioral analytics market and provides a very strong reference point for future customers. We expect to generate revenue in the second half of this year with potential follow-on business in 2019 as this customer moves into the next phase of security.

The third initiative is to leverage our global footprint installed base. In the first quarter, we completed the delivery of our core softswitch and media gateway products for a rapidly growing Tier 1 carrier in Asia which has been our customer since 2014. It has plans to significantly expand network capacity and connect its networks to other service provider networks. We were selected for our ability to meet their large scale capacity needs. This win, and our Ribbon Protect contract that I mentioned earlier, both demonstrate our ability to leverage our distribution capabilities across our large global installed base.

And our fourth initiative is to pursue and utilize strategic relationships and alliances. We believe there are a number of opportunities to acquire, collaborate, or partner in the industry to broaden the offerings to our customers. For example, we continue to strengthen our relationship with Microsoft.

During the quarter, Microsoft selected the Ribbon's Session Border Controller portfolio to deliver secure, integrated voice services to Office 365's newest offering, Microsoft Direct Routing for Teams. As the migration to Teams ramps up later in this year and into next year, we expect the positive impact for our SBC portfolio in this segment.

In total, it was a very first – busy first quarter as we made great progress against our near-term priority of merger integration and realizing cost synergies. At the same time, we executed against our four ongoing strategic priorities, which position us well for the future.

The first quarter progress demonstrates that our strong operational execution and strategic focus continue to enhance our suite of offerings, our scale, and our global footprint. We believe that this gives the company a firm competitive operational manage. Our customers count on us as their trusted partners to help them move to virtualization and cloud. We believe we are in the early innings of a secular shift to virtualization and rhythm, is focused on gaining market share and expanding our market leadership.

I'll now turn the call over to Daryl to discuss our financial results and 2018 outlook in more detail. Daryl?

Daryl E. Raiford

Chief Financial Officer, Ribbon Communications, Inc.

Thanks, Fritz, and good morning, everyone. I'm going to review our non-GAAP financial results for the first quarter 2018, and then provide commentary on our outlook for the remainder of 2018. The slides on our IR website have the details regarding our historical financial performance. Our reporting framework is consistent with what we have presented in prior periods. I encourage you to get these materials from our IR website.

As a reminder, when I refer to non-GAAP in conjunction with the financial metrics, these financial metrics exclude the effect of purchase accounting and other items detailed in our earnings material. Our non-GAAP financial metrics are reconciled for you at the end of both of today's press release and our earnings presentation, and both are available on our Investor Relations website.

Turning to the first quarter, Ribbon produced a solid financial performance that exceeded our expectations. We are pleased with our sales performance as our sales team kicked off the new year armed with the combined Ribbon products and solutions offering directed at both our large installed customer base and our rich pipeline full of new prospects. We believe we have a unique value proposition of real-time communication products [ph] offer (00:13:00) software, hardware, and cloud-native solutions.

In summary terms, our first quarter 2018 non-GAAP financial results were as follows: total non-GAAP revenue was $135 million, gross margin was 57%, loss per share was $0.04, and adjusted EBITDA in the first quarter of 2018 was $1 million. We view these results as a positive indication of solid business performance. Ribbon's first quarter non-GAAP revenue of $135 million, exceeded our initial outlook by $10 million as we benefited from improved product sales due to higher order volume and stronger professional services revenue from accelerated project completions.

Ribbon's first quarter non-GAAP adjusted EBITDA was $1 million. This exceeded our initial outlook by $11 million. Our earnings benefited from higher margin revenue mix coupled with accelerated cost synergies. We are pleased that incremental revenue in the quarter disproportionally drove improved profitability demonstrating the leverage we are building within our business.

Turning to the balance sheet. Cash and investments were $85 million which was up slightly from $83 million at fourth quarter 2017. Borrowings under our revolving line of credit were $20 million, unchanged from year-end and undrawn availability remained unchanged as well at $80 million. In the quarter, we've generated $3 million in cash flow from operations, slightly exceeding the level of capital investment.

Now, I would like to turn to our 2018 outlook. Before I do so, I'd like to remind everyone the Ribbon's new guidance policy that we shared with the investment community on our last earnings call. We plan to guide to annual profitability, namely adjusted EBITDA on a full year basis. We generally do not intend to provide formal numeric guidance on a quarterly basis.

For the full year 2018, we continue to approach overall market conditions with some caution. Given this outlook, coupled with our ongoing process to streamline product offerings, we do maintain our view that the full year 2018 revenue will be lowered by approximately 10% compared with pro forma 2017 non-GAAP revenue.

In terms of full year 2018 adjusted EBITDA, we continue to aggressively focus on completing our merger integration activities, capturing margin improvement and operating expense savings. As Fritz previously stated, we have already operationalized over $65 million in annualized cost savings, we therefore, remain confident in our 2018 non-GAAP adjusted EBITDA guidance of $75 million. And importantly, this full-year 2018 adjusted EBITDA velocity positions Ribbon to exit 2018 at an adjusted EBITDA run rate of at least $100 million.

With that, I would like to turn the call back to Fritz for closing remarks.

Franklin W. Hobbs

President, Chief Executive Officer & Director, Ribbon Communications, Inc.

Thank you, Daryl. In summary, by executing our business integration, we have meaningfully improved our financial profile while moving forward with a commitment to provide innovative solutions, outstanding service, and worldwide reputation representation for our customers. This year will provide a sound foundation for Ribbon going forward on many fronts. As our customers continue to navigate the trends in the industry, we have the products, resources and commitment to help them succeed. All of us at Ribbon are excited about the future.

I would now like to ask the operator to open the call for questions and answers.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Dmitry Netis with William Blair & Company. Please go ahead.

Dmitry G. Netis
Analyst, William Blair & Co. LLC
Q

Thank you very much for taking my question and good progress, guys. My question is kind of twofold. First, I know you don't guide quarterly, but can you give us a little bit of a kind of view into how you expect the revenue to project as you go through the next three quarters. Is there any seasonality sort of built in here? Do we get any choppiness in revenue or was it a steady kind of sequential – I suppose it's sequential off of Q1. But give us a sense how to think about the progression as you go through the year.

Franklin W. Hobbs
President, Chief Executive Officer & Director, Ribbon Communications, Inc.
A

Well, historically the pattern has been that we have a stronger second half and we don't see anything that indicates that our history is going to change, so we feel that that's a good way to think about it. But beyond that, it's – again, it's a chunky business in many regards, but basically we would suspect or expect that the second half will be stronger.

Dmitry G. Netis
Analyst, William Blair & Co. LLC
Q

Okay. And usually – typically your Q2 is better than Q1. Is that a fair assumption?

Daryl E. Raiford
Chief Financial Officer, Ribbon Communications, Inc.
A

It is true that typically the first quarter is – hi, Dmitry. Good morning. This is Daryl. Nice to hear from you.

Dmitry G. Netis
Analyst, William Blair & Co. LLC
Q

Hi, Daryl.

Daryl E. Raiford
Chief Financial Officer, Ribbon Communications, Inc.
A

Good morning. It is true that the first quarter is seasonally the lowest quarter.

Dmitry G. Netis
Analyst, William Blair & Co. LLC
Q

Okay. Very good. And then, second question on gross margins. It was a little, I suppose, below my estimate, but I wanted to see how you're thinking about that gross margin as you move through the year. If you could double click on that and tell us how it plays out as you move forward, that would be great as well. Thank you.

Daryl E. Raiford
Chief Financial Officer, Ribbon Communications, Inc.

A

Well, we are – I mean, we are happy with our gross margin this quarter and we do believe that as cost synergies manifest themselves through the year that that will be improving in conjunction with our other financial metrics like OpEx and things like that.

Dmitry G. Netis
Analyst, William Blair & Co. LLC

Q

Can you give us a little bit more color of what drove in December, it was 61.5%, you went to 57%. What were some of the elements of kind of the lower gross margin? I get the leverage as you build volume and top line revenue, but was there anything specific that – COGs or anything else, some product lines that kind of contributed to a lower margin that you intend to maybe take out as you go through the year given the kind of 10% decline on revenue as you sort of rationalize your portfolios, anything you can give us as to – give us confidence that the margin will build up as you clean up some of the products or anything else that's going on there.

Daryl E. Raiford
Chief Financial Officer, Ribbon Communications, Inc.

A

I think you hit on the major contributor factor which is in the fourth quarter our non-GAAP reported revenue was $169 million. Seasonally, the fourth quarter is always very high, and we do get a lot of leverage across that and that did yield the margin that you quoted. This quarter, we're reporting $135 million or nearly $35 million on a sequential basis reduction, which we expected in terms of seasonality and that revenue coverage across the fixed cost base is the principal contributing factor.

Dmitry G. Netis
Analyst, William Blair & Co. LLC

Q

All right. Great. And maybe a couple more, if I may. On EBITDA, you came in $11 million higher than guidance, which kind of gives you a better view into that $75 million target that you have for the year. Anything – again, is there anything that we should be thinking about as you progress through the year as far as choppiness in this EBITDA progression, or is it sort of a steady buildup and you get kind of the most benefit in Q4?

Daryl E. Raiford
Chief Financial Officer, Ribbon Communications, Inc.

A

Well, EBITDA – we are very pleased with the EBITDA. As I said moments ago, the higher than expected from the initial outlook revenue did disproportionally affect and benefit our EBITDA. And we're delighted with that. That is demonstrating the scale that were – than the leverage that we're building in the business.

Moving forward, I would not expect that we take – as we look over the quarters and just seasonally, I would not expect that we take a step backward on that that we continue to progress towards $75 million – our firm guidance on the $75 million for the full year.

Dmitry G. Netis
Analyst, William Blair & Co. LLC

Q

Okay. My last question is more of a product related if I may. I wanted to get a sense of how Session Border Controllers are doing versus maybe a media gateway business. Anything you can talk to that trajectory sequentially, or on a year-over-year basis, I suppose, whichever way you want to address it that will be good. But just sort of trying to understand how your legacy product is doing relative to growth.

Daryl E. Raiford
Chief Financial Officer, Ribbon Communications, Inc.

A

Right. We said – and understand that just as an overview we said before, and we do still – we maintain it that – we sell solutions to our customers and in the network modernization or network transformation space, the solution mix is highly dependent upon the individual customers specific network configurations, and what type of the products they may need is part of delivering the network transformation solution. With that said, on a pro forma basis to this time last year, softswitch and media gateways were flat and SBCs were slightly up.

Dmitry G. Netis
Analyst, William Blair & Co. LLC

Q

All right. Thank you. That's helpful color. I'll jump back in the queue.

Operator: Our next question comes from the line of Mike Latimore with Northland Capital Markets. Please go ahead.

Michael Latimore
Analyst, Northland Securities, Inc.

Q

Hi, yeah, thanks a lot. Just in terms of the revenue mix, product, service, can you give some general guidance on how you think about that mix, whether this year or just longer term?

Daryl E. Raiford
Chief Financial Officer, Ribbon Communications, Inc.

A

General guidance in how we think about the mix, this year's quarter achieved revenue on a non-GAAP reported basis of $60 million and that is in line with last year pro forma. And services were just slightly less and that's just related to completion timing and the recognition of professional services compared to the prior period. So the mix, we expect to remain roughly in line with what the companies have experienced in the past. There's nothing – no substantial factor that would drive a material mix change.

Michael Latimore
Analyst, Northland Securities, Inc.

Q

Got it. And then, on the – you sort of called out Kandy and then the SBC as a Service, Kandy as a Services maybe growth areas. Can you give us a little color on, as a percent of revenue, what were those categories or as a percent of bookings and then some color on what kind of growth rate you expect from that group over time?

Daryl E. Raiford
Chief Financial Officer, Ribbon Communications, Inc.

A

Well, we are encouraged the funnel and some – and the opportunities that Fritz set out that are within proof of concept and we're moving forward under contract with. The revenue in 2018, we expect to be immaterial. And in terms of Kandy [indiscernible] (00:25:11) Ribbon Protect, our growth rates were – we are evaluating those and watching those. It depends on the robustness of the funnel, the closure rate through the second half of 2018 and the deploy rate from our customers. But we do expect the revenues from both of those on the – to be less material or not material to the – as a percentage to the total company revenue.

Michael Latimore
Analyst, Northland Securities, Inc.

Q

And just last on the enterprise segment. Do you see that kind of growing as a percent of revenue or staying kind of roughly where it's been?

Daryl E. Raiford
Chief Financial Officer, Ribbon Communications, Inc.
A

We do. On an as reported non-GAAP as reported basis – and it's in our investor deck, you'll see that our enterprise to service provider mix did reduce well, and that's with the addition of the GENBAND legacy business within that. And so we're doing a compare back to without the GENBAND business. We do expect that financial metric of 14% for enterprise as a percent of revenue to be – to naturally grow some as we continue to pursue our enterprise strategy.

Michael Latimore
Analyst, Northland Securities, Inc.
Q

Okay. Thank you.

Operator: [Operator Instructions] Our next question comes from the line of Mark Kelleher with D. A. Davidson. Please go ahead.

Mark Kelleher
Analyst, D. A. Davidson & Co.
Q

Great. Thanks for taking the questions. If you look at your – a couple of key partnerships, Verizon and Microsoft, how does the revenue play out to those two? Is it lumpy, is it a consistent growth, is it seasonal? How does the partnership between Microsoft and Verizon play out in revenue?

Daryl E. Raiford
Chief Financial Officer, Ribbon Communications, Inc.
Q

The partnership with Microsoft is primarily related to supplying SBCs and our lower capacity SBCs, and that is a more steady channel relationship. Verizon is a different situation. The Sonus legacy company did report approximately $10 million from sale of software to Verizon of around SBCs – the SBC software product and virtualized product in the third quarter of 20 17, to the extent that more software sales like that occur, they could be – that could be material as deployments occur then that would be more lumpy. It's not really a channel business, it's more of a software sales. So they're not really related to each other very well, with Microsoft being more channel related and Verizon being more service provider deployment.

Mark Kelleher
Analyst, D. A. Davidson & Co.
Q

Okay. And you talked about the rationalizing your product portfolio. I guess that relates to some of the overlap in the SBCs between GENBAND and Sonus. Is that...

Daryl E. Raiford
Chief Financial Officer, Ribbon Communications, Inc.
A

That is true. That is a good size component of that. We did say last quarter that we've undertaken a streamlining of our product portfolio to reduce or eliminate products that do not meaningfully contribute to profitability and that process is ongoing. GENBAND SBCs would be – we are evaluating that and looking at that and working with customers on it as an example.

Mark Kelleher
Analyst, D. A. Davidson & Co.

Q

Okay. And I know in the past, you've talked about the opportunity for industry consolidation. Can you just maybe update us on your thoughts there?

Franklin W. Hobbs
President, Chief Executive Officer & Director, Ribbon Communications, Inc.

A

Well, I think what's becoming increasingly clear to me, as someone who's relatively new to the industry, is that there really is an interesting development going on here, which is as the larger and larger customers, they want broader and broader reach of product line, broader and broader geographical reach. And we think that we are actually uniquely positioned in that regard because we really have been doing this for many years on both of the prior companies. So we think our global footprint is going to be very relevant.

So that means that there may be, we think and I think, there will be opportunities to either collaborate with some of the mid-sized companies, maybe there will be some acquisition opportunities. But we really are open for discussion anywhere along – any of those lines because I do think our built-in asset of being involved across the world is really relevant – increasingly relevant in the way this industry is going.

Mark Kelleher
Analyst, D. A. Davidson & Co.

Q

Okay, great. Thanks.

Operator: There are no further questions registered. I'll turn the call back over to the presenters.

Daryl E. Raiford
Chief Financial Officer, Ribbon Communications, Inc.

Well, thank you, everyone, for joining our call this morning. As we said, Ribbon is very pleased with our results. We look forward to speaking with you as we progress through the months of May and into June. Fritz and I will both be at a number of different conferences and we hope to be able to see you then. Thank you.

Operator: Ladies and gentlemen, that does conclude the conference call for today. We thank you all for your participation and ask that you please disconnect your lines.