26-Apr-2017

Sonus Networks, Inc. (SONS)

Q1 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

Jess Lubert
Analyst, Wells Fargo Securities LLC

Mike 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 Sonus Networks First Quarter 2017 Conference Call. During the presentation, all participants will be in a listen-only mode. Later, we will conduct a question-and-answer session. [Operator Instructions] As a reminder, this conference is being recorded Wednesday, April 26, 2017.

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

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

Thank you. Good morning, everyone. Welcome to Sonus Networks' first 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 this 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 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 our products and services, the timing of customer purchasing decisions and revenue recognition, difficulties leveraging market opportunities, integrating acquired businesses, and lastly, 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-K filed with the SEC and in today's earnings release, both of which are available on our IR website. 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.

Good morning, and welcome to everyone on the call today. I'm pleased to report that Q1 was another solid operating quarter for Sonus, with results in line or better than the guidance we provided in February. The combination of higher revenue and margins in Q1 allowed us to narrow our forecasted operating loss even with a seasonally low revenue quarter. We saw another quarter with book-to-bill ratio above 1, which led to positive operating cash flow and strong DSOs.

The second quarter outlook we provided today reflects our current confidence that we will continue our momentum and we project the first half that is stronger than originally anticipated when first guided in 2017. This solid start should help position us better for the full year, although, we remain heavily weighted to the second half performance to achieve our full year revenue and profitability targets. Our full year targets remain the same, with full year revenue projected to be flat to low-single-digit growth versus 2016 and a non-GAAP EPS of $0.26.

Before I ask Susan to report the specifics of our performance, I'd like to offer some comments regarding our strategic progress. I'm very pleased to report that the large second half project to cut over Tier 1 VoLTE network in North America remains on track. This project replaces an incumbent supplier in the very heart of the wireless network and has visibility throughout the organization. While this project continues, it did also open doors in other business units within this customer.

We were pleased by the March announcement by Verizon that Sonus has been selected as the SBC for the virtual function or VNS in their VNS platform. They also publicly endorsed the work that we've been doing with Palo Alto Networks for more than a year, specifically the coordination between the Sonus SBC and the Palo Alto next-gen firewall.

Beyond this recent announcement by Verizon, we made similar strategic progress with other global service providers which we have not yet shared with you publicly. I currently expect that you will hear additional customers endorsing Sonus as their SBC VNS, as well as our potential collaboration with additional firewall players throughout the remainder of this year.

This strategy of leveraging our leadership in virtualization to collaborate with the firewall industry has the potential to usher in the era of a completely new network architecture, which I've now referenced in earnings calls for more than a year. Let me explain what this collaboration strategy is and why it is so strategically important as the networking industry uses SD-WAN to create a more secure, API-based, end-to-end cloud experience.

The Sonus name is synonymous with voice communications. Our first product offering 20 years ago was a gateway which enabled Voice-over-IP. More recently, we built an industry leading portfolio of SBCs, or Session Border Controllers, which allow network operators to apply policy and security in an all IP environment. So, Sonus has tremendous expertise in securing and managing voice as an end-to-end application running over-the-top of an IP network.

Recently, the industry has seen a significant spike in the attacks on VoIP reported by both service providers and enterprises. IBM began tracking attacks in SIP about two years ago, and has noted a six-fold increase in that time. Things like Denial-of-Service attacks on call centers, fraud, and more recently, efforts to exfiltrate data, which is the highest value attack that can steal customer data have become common plays.

Our customers are asking us to help them with these attacks and with potential future attacks. They are the ones that now view our SBCs as voice firewalls and we are responding to their asks. This is why we are partnering with established firewall vendors, notably Palo Alto Networks, with whom we had collaborated, and last quarter, we announced our mobility use case at Mobile World Congress. The Verizon announcement was specifically related to our enterprise use case.

I offered this point during our February call and it bears repeating today. SPCs are fundamentally firewalls for voice, enforcing security at network edges, that's why they are called border controllers. Unlike a traditional firewall, however, they are already in the flow with an end-to-end perspective. And from this vantage point, we believe they will play a critical role as networks virtualize, decompose and evolve, and then they will co-locate on the edge and collaborate with next-gen firewalls. They will both leverage the strength of each other.

While firewalls provide valuable detection and enforcement of VPIs on critical data flows, protecting the data networks, they struggle with the real-time elements of UC or Unified Communications. The real-time nature of UC operates in call rate that traditional firewalls simply can't do today. Together, however, these two premier sentinels can converge and collaborate to provide an even stronger defense than the two of them acting separately. Ultimately, we believe this will permit a new end-to-end approach. And when this happens, we will realize that what we did was to replicate a software what the old switch architecture did decades ago to run a secure voice network.

For many years we've been investing significantly in R&D, generally in the range of 25% of revenue and more per year. We made a commitment to lead our industry on the path to virtualization and we did so. The challenge for us was to decompose the SBC and leverage our PSX in such a way that we can continue to perform the standard origination and termination functions for voice, while creating a management layer in software that could apply to all flows over IP. This collaboration with the firewall industry is designed to test that thesis, and our early progress is quite encouraging.

As you will hear from Susan now, our core business is sound, and our gross margin progress continues to drive sustained non-GAAP profitability and cash flow. Our balance sheet is strong. The investments we've made over many years to lead the path to virtualized networks are now taking hold. Our customers turn to us increasingly to help them leverage the opportunity now inherent in SDN, which is to create a new overall communications stack that is centered on the cloud-first, while creating an end-to-end control plane that can deliver secure, reliable, and efficient communications networks. The global digital economy is counting on a secure and affordable Internet in the decades ahead. We're thrilled to play our part.

At this point, I'll hand it back to Susan to discuss more details around our Q1 performance, as well as our Q2 and full year outlook.

Susan M. Villare

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

Thank you, 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 have been reconciled for you at the end of today's press release and presentation. The slides on our IR website have the details regarding our historical financial performance and our reporting framework is consistent with that which we have presented in prior periods. We encourage you to get these materials from our website.

Let's now move to slide 3 and take a closer look at our first quarter 2017 non-GAAP financial results. Total revenue was $53.4 million, as compared to our guidance of $52 million. Our non-GAAP loss per share was $0.09, which compares favorably to our guidance of a non-GAAP loss per share of $0.14.

Our favorable per share results were primarily due to both higher revenue as well as strong gross margin performance. Our non-GAAP actual operating expenses of $40.4 million were generally in line with our outlook.

I'd now like to move to slide 4, which is our condensed non-GAAP statement of operations. We have added our Q1 2017 actual results, and as such, you have nine quarters of actual non-GAAP historical performance in one table.

Now, let's move to slide 5, which is our condensed balance sheet. Cash and investments were $128.8 million at the end of the quarter. Days sales outstanding improved to 67 days in the first quarter of 2017 as compared to 74 days in the fourth quarter of 2016. Our DSO goal remains at about 60 days to 65 days, but may vary based upon our linearity within a given quarter.

Q1 2017 mark the third consecutive quarter where our book-to-bill ratio was above 1. Q4 [ph] 2016 (11:50) was the company's highest booking quarter looking back over the past 13 quarters. We had very strong cash collections on these bookings, which resulted in $14.3 million of cash being generated from a decrease in our accounts receivable in the quarter. We remain debt free at the end of the quarter.

Now, turning to slide 6, this contains our statement of cash flows. Please note that this includes cash, marketable securities, as well as short- and long-term investments. In Q1 2017, cash and investments increased by $2.7 million as compared to fiscal year end. We generated $3.6 million of positive cash flow from operations and we did not repurchase any stock under our stock buyback program this past quarter.

Now, let's turn to slide 7, and I'll briefly highlight a few items on our key stats. We had one 10% customer in the first quarter, which was Verizon. Revenue from our top five customers represented 44% of total revenue in our first quarter, as compared to 46% in Q1 of 2016. Product revenue from enterprise customers was strong at 28% this past quarter, this compares to 18% for both Q4 2016 and Q1 2016.

Our flagship Sonus SBC 7000 and Sonus SBC 5000 both performed very well. Product revenue from these products was $12.9 million in Q1 2017, as compared to $12.5 million in Q4 2016 and $14.1 million in Q1 2016.

Now, let's turn to side 8, which summarizes our forward-looking outlook for 2017. Ray provided highlights of our outlook, which I will recap, and then we'll open up the call for questions. We expect our first quarter revenue to be approximately $107 million, with approximately $54 million anticipated in our second quarter. Assuming the $54 million revenue figure in the second quarter, we anticipate a non-GAAP loss per share of approximately $0.10.

If you combine our actual financial results for Q1 2017 with our current outlook for Q2 2017, you should take away that we have modestly increased our total revenue outlook in the first half by $2 million. Our non-GAAP lose per share outlook for the first half is slightly better than originally projected as well and is above current Street consensus estimates.

We will continue to look to reduce spend on older technologies and bake in any redundant facilities related to prior acquisitions. Accordingly, we anticipate a restructuring charge of approximately $1.5 million in Q2 2017, which we did exclude from our projected non-GAAP outlook. These charges relate to the continuation of the Sonus and the Taqua restructuring plans, which we announced in the second half of 2016. We believe these restructuring programs will be essentially complete by the end of Q2 2017.

Turning now to full year 2017, as Ray previously mentioned, we maintain our revenue and our non-GAAP fully diluted earnings per share outlook for FY 2017 that we provided on our February call.

Well, that concludes our formal remarks. Operator, we are now ready for our first question.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from Jess Lubert, Wells Fargo Securities. Please go ahead.

Jess Lubert
Analyst, Wells Fargo Securities LLC

Q

Hi, guys. Good morning. Thanks for taking my questions. A couple of questions here. Maybe just to start, it sounds like you made some good progress with the large competitive replacement, you highlighted last quarter, it sounds like maybe you've upsized that. You've made some progress with Verizon. You alluded there are some other carriers that you're working with. So, I guess, I was just hoping you could provide a little insight into kind of how you're thinking about visibility into the second half of the year, if things there haven't improved?

And then, Ray, maybe you could talk a little bit more about how you see the Sonus security story playing out from here, and to what extent this is a 2017-2018 revenue opportunity or if this is something that plays out over a longer period of time?

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

A

Sure, Jess. Good morning and thanks for the questions. First, we have made tremendous strategic progress. I'm very pleased and really proud of the team. The work that we're doing on the large Tier 1 VoLTE project is massively complex. It has actually started with a high level of trust between us and that Tier 1, and that trust has just expanded significantly across the board, because we're delivering. Now, there's – we're not done yet, it will score in the second half of this year. But we're through the FLA process in a number of different areas, we've made most of the complicated call flows.

So, I couldn't be more proud of the team for doing what we're doing, and I feel personally comfortable, having met with most of the senior executives on it, that it's reflecting very, very well on Sonus, and it's become basically a referenceable success that's really helping us strategically around the world. And by the way, it's completely virtualized, so it speaks to our leadership in virtualization, everything there is software-based. When we do get the chance to talk more about it – I think it would be even more impressive overtime, and I expect we'll be able to talk more about it on the next call. With regard – it hasn't been upsized at this point in time, but it has led to additional opportunities both in that account and in other accounts.

Let me speak to the visibility issue and then we'll talk to security. The visibility into the second half is improving. Another book-to-bill quarter over 1 helps. Our second quarter is shaping up very nicely, and right now is on plan to be book-to-bill above 1 and potentially even more so. But we still have a steep hill to climb in the second half, so we're not going to take our pack off. The third quarter is shaping up very, very nicely, and it's right now likely to be where that Tier 1 project comes in, but when we guide Q3, we'll let you know, because if it moves to Q4, so be it.

And we still have some work to do in Q4, but that would be traditional for us at this point in time of the year. We would never have visibility into Q4 on a bottoms up basis, it's much more on a fumble basis. I hope that answers your question, Jess. This one project is probably the only big deal risk in the second half. There are some other relatively large deals, none of this size, and all of which are established technologies [audio gap] (19:15) relationships with nowhere near the risk associated with the project that we've disclosed. So, I hope that's helpful.

On the security story, I am very, very encouraged by the pace of our progress. The fact that we've had at least one Tier 1 come out and endorse our approach was quite gratifying for me. They literally asked to do that, and we of course welcomed that. We are making similar progress with other Tier 1s around the world. We are making similar progress with other firewall vendors. This is an industry push. It is now clear that the voice architecture is one of the options people have to implement SD-WAN. You can either use the Big Data analytics engine to extract data from network nodes, create context and push it back down. And as you approach real-time over the next few years, you'll start to approach a network effect of dumb network elements or you can use which worked for the last 50 years or more, which is a control plane that created end-to-end applications which is what voice is.

So, out of the dust and ashes, if you will, of managing and securing voice for a very long period of time is now being recognized as an agile control plane, and it rests on the higher layers of our SBC function, which was a control plane that had an on-board PSX. And the fundamental policy architecture that has been endorsed in – and basically fits – there's hundreds of PSXs out there among some of our Tier 1 customer.

So, whether or not it scores in 2017 or 2018 or it takes longer, I expect it will have an impact on 2018. It has the potential to have a marginal impact on 2017. We're going after customers together with our Tier 1s. We're in QBRs, EBCs. People use different terms for these things, but we are out on the road with executives from our Tier 1 customers, approaching some of their largest enterprise customers, explaining this strategy. There will be [indiscernible] (21:20) later this year and into 2018, but as far as revenue, it would be risky to call it material in 2017, but I would expect it to be material in 2018. So, this is not that far out, Jess.

Jess Lubert Q
Analyst, Wells Fargo Securities LLC

And then just one more for Susan. It looks like gross margins were a bit weaker than we would have expected. So, I was hoping to understand what happened there, particularly on the product side, given the SBC 5K and 7K seem to perform well and it sounds like the virtual story is getting some lift.

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

Sure. I mean it's just really a function of the overall revenue number. So I mean, obviously, when we go back to the levels we saw in Q3, Q4, we'll be well above 70%.

Jess Lubert
Analyst, Wells Fargo Securities LLC

Q

Thanks, guys.

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

A

Yep.

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

A

Thanks, Jess.

Operator: Thank you. Our next question comes from Mark Kelleher of D.A. Davidson. Please go ahead.

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

Q

Great. Thanks for taking the questions. Just to go back to the large deal coming in in Q3, just to understand that better. Is that – did I understand that that's going to be recognized as one deal, one – it either comes in or it doesn't, it's not multiple pieces? And the second part of that would be, what's the service element of that? Should it be split evenly between service and product? And then will that service continue on and what effect would that have on gross margins? Thanks.

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

A

Sure. Thanks, Mark. Last question is easier. The effect on gross margins would be very positive. So, when it scores, it'll probably spike our margin profile a little bit, depending on how it scores. It will probably be balanced between Q3 and Q4. Because when it scores, it'll probably go ratable between then and the end of the year. We'll talk more about it as it gets closer. But, hopefully, this is the kind of color that is at least appropriate for you now, and I'm trying to be responsive to your question. With regard to the product versus services mix, I think, it will be largely product when it scores.

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

Q

Okay. Great. Thanks.

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

A

Sure.

Operator: Thank you. [Operator Instructions] Our next question comes from Mike Latimore, Northland Capital Markets. Please go ahead.

Mike Latimore
Analyst, Northland Securities, Inc.

Q

Hey, Ray. Thanks. I guess, you mentioned on the large project that you're opening doors with, I think, in other groups within that carrier. I guess, are you talking generally getting more into the access side of things there or what do you mean by that?

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

A

We're definitely evolving into access type discussions, but if you think about – first of all, in the enterprise side, being a VNF in the white-box solution, which they call their Virtual Network Services platform, VNS, that is access, if you will, on the enterprise side for sure. But with regard to the VoLTE side, the access side of the business is still largely in front of us. We're dealing on the core right now.

Mike Latimore
Analyst, Northland Securities, Inc.

Q

Right. Okay. Got it. And then, did you make a comment that first quarter bookings were one of your largest bookings quarter ever or I just kind of heard something like that or [ph] maybe that's not. (24:35)

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

A

No. That was a reference to the fourth quarter bookings.

Mike Latimore
Analyst, Northland Securities, Inc.

Q

Fourth quarter. Okay. Got it. And then, AT&T, it looks like it was not a 10% customer in a lower revenue quarter here. I guess, any general comments on AT&T relates to 2017 here?

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

A

I feel very good about AT&T and how it's stacking up in 2017, and even more so beyond that into 2018 and 2019. I would expect us to be a very large part of Domain 2.0 or even Domain 3.0 as it evolves, which is probably the likely outcome by the end of the year.

Mike Latimore
Analyst, Northland Securities, Inc.

Q

Great. And then just as you look at the pipeline, you mentioned sort of virtualization a lot. I mean, if you look at your pipeline on the product side, how big is software, let's say, as a percent of the pipeline?

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

A

One more time on that question Mike or Matt, I'm sorry.

Mike Latimore
Analyst, Northland Securities, Inc.

Q

Yeah. Just – in terms of the product pipeline, software or virtualized products as a percent of the pipeline, what's that looking like now versus even the six months ago or let's say a year ago?

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

A

It's increasing in two ways. One, there are more projects that are coming to us that have the potential to be purely virtualized. And then, of course, there's a lot of fill in that we're selling software on top of like 7K, 5Ks that were sold with partial software fills. So, that's kind of razor/razor blade. So, we're definitely selling more blades, which is coming in with software content and driving margin progress. And in some cases, it's coming to us purely virtualized.

Certainly, when we move into the VNF piece, we're going to be into a purely virtualized revenue recognition model – a revenue model, I should say. And when we move into the cloud, which is probably the next most exciting part of this story, which I'll share with you towards the back end of this year, we'll be deploying in the cloud and pure software. These issues are a little harder to forecast, because we'll probably drive our transition to subscription as well. I would expect us to have a meaningful portion of our revenue in 2018 to be at least as a subscription revenue model.

Mike Latimore
Analyst, Northland Securities, Inc.

Q

All right. And just last on Microsoft's Skype for Business, do you expect that kind of revenue segment to be – I don't know – flat this year versus 2016 or some growth there?

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

A

Probably flat, potentially have a little growth in the back half of this year. More than likely, we'll see the growth in 2018. Microsoft Skype for Business is definitely evolving from SIP termination on-prem, us versus AudioCodes, where you just kind of fight to the finish, and it's meeting the channel, and it's very challenging. I mean, we do fine, but it's very hard to be differentiated. So, it's hard to get excited about that.

They are now evolving very nicely to a hosted environment, where our core assets really shine, our scale really shines. And frankly, they're starting to peer or interconnect, if you will, at the API layer – or at least they're exploring that with various other cloud players. And so, our peering background is going to help quite a bit in Azure and in Skype for Business. Those two separate clouds will probably converge in 2018. So, I'd say from a revenue point of view, the Microsoft relationship is probably flat, but from a strategic point of view, the Microsoft relationship is quite positive for Sonus right now.

Mike Latimore
Analyst, Northland Securities, Inc.

Q

All right. Thanks.

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

A

Thank you.

Operator: Thank you. At this time, I'd like to turn the conference back over to our speakers for any closing remarks.

Raymond P. Dolan

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

Thank you all very much for your support. This has been a journey here as we continue to invest in R&D. But I really – I'm excited about the amount of indications from our Tier 1s and from our large enterprises as to how positive they see our focus on virtualization. So, we look forward to sharing results in the second half. 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 all lines. Thank you and have a good day.