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Sonus Networks, Inc. (SONS)

Q3 2014 Earnings Call

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Mark T. Greenquist
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Raymond P. Dolan
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OTHER PARTICIPANTS

Natarajan Subrahmanyan
The Juda Group

James M. Kisner
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Theodore Joseph Moreau
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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by and welcome to the Third Quarter 2014 Results 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 today, Thursday, October 23, 2014.

I would now like to turn the conference over to Patti Leahy, VP, Investor Relations Sonus Networks. Please go ahead.

Patti Leahy
Vice President, Investor Relations

Thank you and good morning. Welcome to Sonus Networks' third quarter 2014 financial results conference call. Joining me on the call today are Ray Dolan, President and Chief Executive Officer; and Mark Greenquist, Chief Financial Officer.

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 a transcript will be available on our IR website after the call. During our prepared remarks, we will be referring to a presentation with supporting information. Please take a moment to locate this on our IR website.

As shown on slide 2, please note that during this call we will make forward-looking statements regarding items such as 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 revenue recognition, difficulties leveraging market opportunities, the impact of restructuring activities and our ability to realize the benefits of acquisitions.

A discussion of these and other factors that may affect 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. 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 measures is included in our press release issued today as well as in the IR section of our website.

So with that, it's now my pleasure to introduce Mark Greenquist, Chief Financial Officer of Sonus.

Mark T. Greenquist

Chief Financial Officer

Thanks Patti and good morning everybody. Let me turn to slide four for the framework of our prepared remark today. I'll review the highlights from the quarter, including our financial results and outlook before handing off to Ray to discuss our commercial traction and our continued focus on shareholder friendly initiatives. Then we'll open it up for your questions.

Turning to slide 5, Sonus delivered another strong set of results this quarter. My comments are on a non-GAAP basis, which, as Patti said have been reconciled for you in today's press release.

Total revenue was up almost 8% compared to the third quarter of last year, and our growth-related revenue was up 41% year-over-year. We had two 10% customers this quarter, both at approximately 17% of revenue; they are Century Link and AT&T.

The channel was a strong contributor to our revenue this quarter, up 50% compared to the third quarter of last year. Channel product revenue represented 38% of our total product revenue this quarter, which was another record high. There were a number of large channel deals in backlog being scored this quarter, so we do expect the Q4 number to move back toward our year-to-date average of about 28%.

So we are very happy to see our continued focus on growing our channel revenue is paying off this quarter. Contributing to this success is excellent traction we are seeing with the business services arms of large Telco's around the world. In fact AT&T business services which is included in our channel revenue, comprise 30% of AT&T's total revenue for the quarter, or around $3.7 million.

The business services arm of a large Western European service provider also recently selected Sonus over one of our competitors to support the Microsoft Lync managed service deployment for a global company with over 90,000 employees. Gross margins continued their upward trajectory this quarter, up over 400 basis points compared to the third quarter of 2013, and I'll discuss gross margin progress further in just a moment.

Operating income was up 10% year-over-year and net income was up 26% year-over-year, which represents the sixth straight quarter of profitability for the company.

Now I'll turn to slide 6. I've just covered most of this information, but here you also have our results compared to our guidance. The takeaway here is that we have been consistently meeting or exceeding our top and bottom line guidance, and this would be a good time to mention that going into 2015 when we provide our annual guidance on the February call, we will most likely move away from providing growth revenue guidance as a subset of total revenue and will simply provide total revenue and EPS guidance for the full year, as well as total revenue, gross margin, OpEx, and EPS for the next quarter out. And of course, we will continue to provide color on product, geographic and sales channel trends in our actual results that drive our growth so that you know where the business is gaining the most traction.

Let's turn to slide 7 for a deeper dive on gross margins which are our core part of what's driving our operating leverage. Here you can see a very nice improvement of 940 basis points over the past two years. Services margins expansion has been a key driver of this improvement and we've made a concerted effort to reduce costs in this area while simultaneously moving the organization from a US-centric support model to a truly global organization that now follows the sun 24/7, 365 days a year. Another key driver of our gross margin expansion has been a product mix shift towards more software and license sales. Now today, this is primarily being driven by incremental licenses or cards on existing chassis deployments. You can think of this like the classic razor/razor blade model.

In the future though, as NFV becomes a bigger part of our customers' networks, we should also see higher margin software content increasing. And the last major gross margin driver is that we are moving to more standards-based products which are much less complex in the old Sonus model, which customized far more often and for far fewer customers. In today's model, we are better able to scale with a channel and customer base that's growing rapidly.

Let me turn to slide 8. Slide 8 lays out our guidance for Q4 and the full year. And please note that my comments will now pertain to fourth quarter on a non-GAAP basis. Total Q4 revenue is expected to be between $76 million and $82 million. As noted in today's press release, the fourth quarter historically is the biggest revenue quarter for Sonus, due in large part to service provider spending cycles and the yearend budget flush.

We are very pleased that our revenue linearity has improved this year, and I'll show you some data on – behind that in a moment. And as we have improved our systems and forecasting tools, our sales visibility has also improved compared to prior years. However, based on the current market environment and what many of our peers have already suggested, we believe it is prudent to consider the possibility of limited to no budget flush from our North American service provider customers this quarter.

Now to be clear, we believe that we actually have a reasonable line of sight to reach the top end of our guidance, but we want to be conservative to the downside in this current environment. Still, we remain confident in our ability to achieve our fourth quarter EPS outlook of $0.03 and our full year EPS outlook of $0.07, given strong year-to-date performance, the continued expansion of gross margins and ongoing disciplined cost control.

To fill in the other pieces of guidance for Q4, gross margins are expected to be in the range of 65.5% to 66%, and OpEx is expected to between $43 million and $46 million. We also forecast 249 million diluted shares outstanding at the end of Q4 and 255 million diluted shares outstanding for the full year. The difference between those numbers is due to the fact that these are weighted average calculations over different periods of time.

And then one final comment on our outlook, based on the visibility we have now, we are also comfortable with the current consensus estimates for the first quarter of next year of $74 million in revenue and $0.01 of non-GAAP EPS. I wanted to mention this since there is understandably a fairly wide range of expectations out there right now. And of course this view is – can change, and if it does, we'll update it when we provide our annual guidance for 2015 on our February Q4 earnings call.

Slide 9 provides the revenue linearity trends I mentioned a moment ago. You can see that 2014 is shaping up to be the most linear or most evenly distributed year that we've had in at least the last five years.

The midpoint of our guidance assumes $79 million of revenue which is about 26% of the full year's revenue. The incremental revenue we need to deliver from Q3 to Q4 to achieve that midpoint is also less than what we have needed to deliver over the past few years. The average over the past three years, excluding the fourth quarter of 2010 which was abnormally high, has been about $11 million. This quarter we will need to deliver approximately $6 million of incremental revenue over Q3 in order to achieve the midpoint of our Q4 guidance.

The main point I want to make here is that the hill this fourth quarter is not as steep in prior years, and the range we have provided derisks it further in order to account for potential reduced budget flush which we estimate could be as much as a few million dollars. So, in short, we feel quite confident that we can achieve the bottom end of our revenue range which we see as a conservative number. But let me tell you, we are targeting, and have a reasonable line of sight to deliver the top end.

Let me turn to slide 10. This next slide provides a good view of our year-over-year growth-related revenue trends. This progress is at the heart of what is driving our top-line growth and you can see good year-over-year progress on the next slide. You can see the sequential progress that we're making.

On slide 11, you can see that our growth-related revenue for 2014 is now well over half of our total company revenue, and we expect this to further strengthen in 2015.

I'd now like to hand it off to Ray for his prepared remarks. Ray?

Raymond P. Dolan
President, Chief Executive Officer & Director

Thanks, Mark and good morning, everyone. Let's turn to our third quarter commercial highlights on slide 13, and let's begin with a market perspective. A key leading indicator for our growth business is SIP trunking adoption. We continue to see robust growth in SIP trunking which analysts project to grow about 35% in 2014.

North America is the leading market with about 20%, and we're seeing the markets in Asia-Pac and Europe developing nicely as well. Robust SIP trunking adoption leads to robust demand for UC applications in IP Services, all of which is good for Sonus. The migration to SIP trunking is still in its early days and we see no sign of it slowing down. We made several announcements recently regarding enhancements to our partner ecosystem, in particular with Genesys, Microsoft, and BroadSoft.

Let me describe each of those in turn. Our entire portfolio of SBC's is now certified for interoperability by Genesys, a leading provider of customer experience and contact center solutions. Sonus is also recognized as a Genesys Silver Technology Partner. Our SBC solution secure and enable real-time communications across different PBXs, contact center platforms and end points to help deliver an exceptional customer experience.

We help protect voice, video and other forms of online collaboration from interception and fraud so that customer conversations and sensitive information are secure. This partnership is also a good indication of our strong position across the broader call center market.

In addition to Genesys, we announced that the Sonus SBC software edition or what we call the SBC SWe achieved Microsoft Lync 2013 qualification for SBC deployments. The ability to deploy a Lync-qualified software SBC via virtual servers already supporting Lync environments enables enterprises to rapidly deploy new networking resources. With the software SBC, enterprises can quickly turn up SBC functionality within existing virtual environments to deliver built-in media transcoding, network security such as encryption, authentication and denial-of-service protection, SIP interworking, intelligent call routing and multi-vendor interoperability with Lync deployments.

Sonus SBCs are installed at the border between the internal Lync enterprise voice network and SIP trunking services at the network border to enable a more seamless flow of SIP-based media for UC. Integrating these powerful network devices into Lync deployments protects, secures, simplifies and standardizes real-time communications such as voice and video.

This month we also announced that our entire portfolio of SBCs has completed interoperability testing with BroadSoft's BroadWorks platform. This integrated solution from Sonus and BroadSoft will accelerate the deployment of secure, hosted cloud based communication services by decreasing installation challenges.

BroadSoft's service provider customers now have access to our complete portfolio of hardware and virtualized SBCs, scaling from low session count densities serving the enterprise branch offices to the industry's highest density requirements to serve large service provider core infrastructures.

BroadSoft is deploying Sonus SBCs for access and peering as part of its BroadCloud managed service offering, giving BroadSoft the flexibility to deploy the SBCs virtually or as appliances as well as the ability to easily scale with business needs.

The traction we are seeing with our partners and our results this quarter speak to the fact that our competitive moat is widening. I believe we are without question leading the market in virtualization.

I just mentioned the software-based SBC. It recently received the 2014 Unified Communications Product of the Year Award. And earlier this month, we introduced software versions of our centralized policy and routing engine, we call that our PSX, and our Diameter Signaling Controller, or our DSC. These are the logical next steps in our overall virtualization strategy as we widen our leadership in virtualization.

Sonus is the only brand in the market to leverage a common, hardened code base across our hardware and software portfolios for core communications networks, which gives our customers a holistic investment protection. These virtualized offerings address service provider and enterprise requirements for NFE, NFC and enabled technology in order to scale cloud based delivery platforms for real-time communications.

One very exciting and new development is that we are now working on deploying our SBC in the Amazon Cloud in order to provide SIP trunking termination, security, and policy for hosted UC services. The commercial opportunity here was brought to us by a recognized Lync partner and systems integrator. Based on our customer interest, we are working quickly to bring this solution to market.

Moving to large-scale SBC deployments, we continue to see strong market interest with the Sonus SBC 7000. As we discussed on the call last quarter, this was the fastest time to revenue for any new product in our history. Q3 was a strong quarter for the 7000 and we expect Q4 to be even stronger. We are seeing very broad interest for this product from all types of service providers, cable operators, and even large enterprises. Diameter remains a very exciting market opportunity for Sonus with a market that analysts now project will grow at a CAGR north of 50%, from about $200 million in 2013 to nearly $2 billion in 2018.

We have seen some good early indications of success, having recently won a nice piece of Diameter business together with Kapsch, a distributor in Europe at BICS, which is Belgacom International Carrier Services. This is for the deployment and maintenance of the signaling network to carry BICS' international wholesale traffic to more than 500 carriers worldwide.

This quarter we scored another new Tier 1 customer win in Asia-Pac. This win was for SS7 signaling with licenses to purchase Diameter in the future. Sonus in fact beat the incumbent signaling vendor for this business based on the strength of our product roadmap. This brings us to seven new Tier 1 wins in the last five quarters with five of those outside North America. To those tracking it, we are now selling growth-related products to 44% of the top 50 SPs around the globe. This is solid progress, but we still have a lot of opportunity to penetrate more top service providers, particularly outside North America.

Let's turn to slide 14. Sonus has a very strong balance sheet with more than %150 million in cash and virtually no debt. We are also now consistently generating positive cash from operations and this positions us with total flexibility to build organically, continue to make opportunistic growth acquisitions and fund our ongoing stock buyback program.

We have repurchased approximately 44 million shares to-date, which represents about 16% of total shares outstanding since the buyback began. We bought these shares at an average price per share of $3.38 and we have approximately $26 million available for future repurchases under the current plan.

I'd like to spend a minute now on the topic of shareholder feedback because we have taken some recent actions that I want to highlight for you today. You've heard me say before that I believe I have the best commercial hand and I've ever been dealt in my roughly 30 years in the business world. As I stand here today, I feel stronger about that statement than ever before. I base this on the fact that we are not just relevant, but we are increasingly strategic to some of the biggest service providers in the world. I love our odds and I am incredibly proud of our team for getting us to this point. That said, I am fully aware that it can be disheartening to our team and of course to our shareholders to see our valuation not yet fully reflect the progress we are making.

We move forward with the perspective you would expect us to have, which is to ensure that the decisions we make today are also the right decisions for our business tomorrow. We've worked hard over the past couple of proxy cycles to solicit shareholder feedback. Some of the things we have done recently in response to that feedback are to eliminate our shareholder rights plan or poison pill which had been in effect since 2008. We have also enhanced our pay-for-performance practices for example by providing the specific financial metrics for our cash bonus program, instituting share ownership guidelines for myself, direct reports, and the board and adopting a formal clawback policy.

Most recently you may have seen that we filed a definitive proxy to approve two proposals on December 2, one of which is to give our board the authority to do a reverse stock split. I want to be clear that we believe we are doing this from a position of strength. In fact we had the approval to do a reverse split about four years ago, but we concluded that was not the right time when we still had so much of our operational turnaround in front of us.

Over the past six to 12 months we have heard many current and potential investors tell us that Sonus is a much different and much better company today, but it still has too many shares outstanding and that we should correct it. So we are also listening to this feedback. While it wouldn't change anything fundamental with the business, there are a number of benefits to doing a reverse stock split, one of which is that we can shine a brighter light on our earnings performance.

Slide 15 shows a good illustration of this. This data shows that while we met our guidance this quarter, when rounded to the nearest penny and using our current share count, a smaller and arguably more appropriate share count would have uncovered a significant EPS outperformance depending on the split ratio.

As Mark said earlier, Sonus has now delivered six consecutive quarters of positive non-GAAP earnings and met or beat our guidance in every one of those quarters.

Our valuation is increasingly underpinned by the fundamentals of our operation and performance, yet this progress is arguably overshadowed by the high number of shares we have outstanding. So among other potential benefits of reduced trading volatility and lower transaction costs, doing a reverse split would better portray our earnings performance. We encourage you to read the definitive proxy filed with the SEC on October 15 for more details in advance of our Special Shareholder Meeting on December 2.

So let's tie all this together back to our performance on slide 16. The transformation that's taking place at Sonus is clear. Our revenue is growing and our margins are expanding. We are generating positive earnings. In fact, we raised our earnings guidance earlier this year based on that strong performance.

Turning to slide 17, these trends all point to strong operating leverage which I believe is one of the most exciting aspects of our investment thesis. Our strong execution allows us to confirm the 10-10 financial framework for 2015 that we first laid out for you at our Investor Day in March.

And turning to the final slide, slide 18, we will be attending a couple of investor conferences in New York and getting on the road in other parts of the country this quarter. We hope to see as many of you as possible during this next outreach period.

And with that we'd now like to open the call up for questions. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you very much. [Operator Instructions] And our first question comes from the line of Subu Subrahmanyan with The Juda Group. Go ahead.

Natarajan Subrahmanyan
The Juda Group

Q

Thank you. Two questions, first on the guidance for the next quarter, Mark as you mentioned that there is some variables in terms of year-end CapEx budget flush, can you talk about which product segments have specifically impacted it? Is it fairly broad based? Does it impact the growth products more versus kind of legacy? And thinking about your guidance for next year, the 10% revenue growth, can you talk about – I know you are not breaking it out too much, but is the trajectory similar where the legacy products are declining somewhere north of 20% and growth products are offsetting that?

Mark T. Greenquist
Chief Financial Officer

A

Sure. With regard to guidance, I didn't mention it in the remarks, but if – you know on the chart you can see that we also have a pretty wide range for the growth products as well. So it's maybe a little bit less wide than the total, so specifically to your question I think we are mainly, as we look and contemplate like what we think the budget for us in the fourth quarter is, we're thinking it has more to do, or probably the majority of it has to do with growth products versus legacy.

And then with regard to the question about next year and revenue growth, I think largely we believe that the trends that we've been seeing in growth versus legacy are pretty much still intact. And by that I mean – we had talked about the market growing probably in the 20s for SBC and certainly Diameter combined with that. And then with legacy product revenue, we continue to think that that is also – declines pretty rapidly, probably in line with what we've seen this year, which is in the 20s, but that the maintenance declines at a slower rate, probably high single digits, maybe 10%. So we've been talking about those sort of percentages consistently with regard to the various components of revenue. And the assumptions pretty much stay the same for what we are thinking about next year.

Natarajan Subrahmanyan
The Juda Group Q

And just a quick follow-up on gross margin; you know strong gross margin number this quarter. You are guiding it down a little bit for next quarter. Is it just mix and can you just kind of talk about trends for gross margin going into next year, what are the variables?

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

Yeah, it's exactly that; it's mix. And as you've seen this year in fact on the chart that we've got in the presentation, quarter-to-quarter gross margins can jump around a little bit but the trend is pretty steady. And we think based on our guidance we are looking at as much as a 300 basis point improvement year-over-year, which would follow a 300 basis point improvement in '13 versus '12. And while next year – not going to run ahead of myself and be talking about guidance in 2015 I think we are still on the page of what we talked about before, which is, we think we can continue to make good incremental improvement in gross margins on a going forward basis.

Natarajan Subrahmanyan
The Juda Group Q

Got it. Thank you very much.

Operator: And our next question comes from the line of James Kisner with Jefferies. Please go ahead.

James M. Kisner
Jefferies LLC Q

Thanks guys. Congrats on the strong Q3.

Mark T. Greenquist
Chief Financial Officer A

Hi, James.

James M. Kisner
Jefferies LLC Q

Yeah. Hey there. Congrats on the strong Q3 and thanks for giving us some visibility into Q1. So just wanted to understand the guidance. I mean just limited to no budget flush, I mean is there really something that you're getting? Is there some kind of impact you're seeing in your bookings? Is it conversation with customers or are you reading the headlines? Like just what's the overall kind of driver here to your conservatism in Q4?

Mark T. Greenquist
Chief Financial Officer

A

Yeah. So James, as we've tried to say in our prepared comments, it is more macroenvironment looking at just limited budget flush as a potential option. And so what we try to do is just open a range to that. But, no, I wouldn't call it any weakness from the standpoint of Q3 bookings. To the contrary, what I would say is that we just have to – we have to be aware of the macroeconomic environment out there and some of the spending trends that we see from some of the largest service providers. Okay?

James M. Kisner
Jefferies LLC

Q

Okay. So one thing that – particularly on the test side we've seen some folks say that there has been a little bit of some pausing here and there around just SDN, architectural decisions that – certainly at least one major large carrier in North America. I mean, do you think you are seeing any of that at all? Is there any potential impact from that?

Mark T. Greenquist
Chief Financial Officer

A

So I have said on prior calls, James, here's how I'd try to answer that question, because I want to put this in context; I don't want to be just a simple yes or no there, although that tends to be the easiest to answer to quote. These transitions to SDN are choppy by their nature because, remember, there was a Domain 1.0 before there was a Domain 2.0 and who knows, maybe there will be a 3.0. People try to figure out – the basic thing that's happening here is the transition from dedicated networks with dedicated end points running dedicated applications, voice, video, data, et cetera, to an application suite driven mostly in the cloud running across an IP architecture. So that cloud architecture is working really well in IT, but most of the revenue is still living in those old MPLS architectures and nailed-up architectures.

The transition of that revenue is what people are kind of on again, off again, so to speak with, because they can't break that revenue. All right? So what they – and all that revenue is real-time stuff. The majority of the volume is best efforts; the majority of the revenue is in the real-time suite. And that transition across that chasm is what I think you're seeing some false starts on, and I would expect those false starts to continue. I think they are in the run rate of the industry today. I don't think that suggests or implies any slowdown or speedup, but when we get across that chasm I think you'll see a fairly large secular growth up as that new cloud architecture takes hold. That's the transformation that Sonus is going through as well, and it's a very healthy thing for us.

That's – when I indicated that we are increasingly strategic to those Tier 1s it's because we're in increasingly senior and strategic discussions with all of those Tier 1s around the world, discussing how to move their revenue into that cloud architecture without breaking it. It's the simplest way I could describe it to you.

James M. Kisner
Jefferies LLC

Q

Okay. Just one last quick – thank you, and just one quick one. So obviously you've had pretty strong data points in the iPhone 6 launch. It's the first major phone, or at least the – very significant phone to support voice over LTE, I mean, is there any visibility for you in the interconnect side? Do you kind of see a pick-up there? I mean, could you potentially have some accelerating capacity additions as a result of the iPhone 6? Just any kind of initial anecdotes or just data points around that from where you sit?

Mark T. Greenquist
Chief Financial Officer
A

The simplest answer is, no. James, I don't think that the iPhone 6 by itself drives this. I do think that the transition to a real-time suite, not just voice, but the entire real-time suite, and I think video is going to be the bigger driver. We said that for a number of quarters now, if not longer. It's driving up to video. Why? Because it unlocks a new revenue source, and a new revenue source justifies expansion in capital budgets.

To me – I just boil this down to really simple metrics. If we can get behind driving revenue for service providers, they can let out additional capital. Until they do – until someone helps them do that it's going to be a measured CapEx environment for all service providers. Right? I don't think iPhone 6 has yet, and I don't expect it will for another couple of quarters really unleash VoLTE or video. But it certainly sets the table for it.

James M. Kisner
Jefferies LLC
Q

All right. Thank you very much.

Mark T. Greenquist
Chief Financial Officer
A

Sure.

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

Thank you.

Operator: Our next question comes from the line of Ted Moreau with Barrington Research.

Mark T. Greenquist
Chief Financial Officer
A

Hi Ted.

Theodore Joseph Moreau
Barrington Research Associates, Inc.
Q

Good quarter guys. Just kind of curious, you talk a little bit of – some backlog helping to drive Q3. So just wondering how you are thinking about backlog going into Q4 and how much could come out of backlog?

Mark T. Greenquist
Chief Financial Officer
A

So over the last couple of years, I mean – and we've talked about this before, I mean the business has changed where it's not as much of a backlog business as it used to be and it's more of a turns business. I wouldn't call it a turns business, but it's – with those two bookends we've moved toward being more of a turns business. So I guess in Q4, I mean I expect kind of the same that we've seen over the past couple of quarters this year with regard to how much of the revenue is going to be generated on backlog and how much is going to be booked, shifting revenue in the quarter. I'm not – so my going on and on here, I'm sorry, but I mean I'm not seeing any different trend or any big movement or changes with regard to those sorts of metrics.

Theodore Joseph Moreau
Barrington Research Associates, Inc.

Q

Okay. Sounds good, and then during the prepared remarks you guys were taking about the various partners. Could you rate those as far as what you believe may be the most contributors to revenue growth over the, say 2015? And then I noticed Juniper wasn't listed on that slide and I thought I saw a press release about your interaction with Juniper fairly recently. So could you provide an update on Juniper?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure, Ted. This is Ray. Those three partners that we dealt with there, Genesys, Microsoft Lync and BroadSoft, BroadCloud, those were all, if you will application suites and what I was trying to describe there is the opportunity for us strategically to embrace those strategies as they all drive, if you will, the transformation of the edge of the network in the access part of the network, call centers as well as the enterprise and to a certain extent the small, medium business in a hosted environment for service providers.

Juniper would be more of a core infrastructure player down the stack in Layer 3. And we maintain a vibrant technology partnership with Juniper, but it wasn't as much a go to market strategy that's why we just didn't bring them up in this call. But it remains a good strategy, a solid strategy; in effect is consistent with all of the higher layer strategies in all of those cases because Juniper serves all of those environments as well, all right?

So – and I wouldn't necessarily stack – rank them. I do think the call center environment in general is an important category for us to penetrate, and penetrating one of the industry leaders is an important data point for us. We've moved beyond that. In fact last quarter we mentioned that we had penetrated – we had scored a call center environment offshore, and that was not Genesys.

So just – I just use it as a large name so that you could understand the significance of our adoption into that space; because SIP trunking and call center development are running in parallel on global basis. The move into BroadWorks and BroadCloud is a big deal for us on the service provider side and the interoperability between the BroadCloud environment and the Microsoft Lync environment is another very important thing for us to help both of those environments work in the multi-vendor marketplace that we have today.

So that's – I hope that's enough color and background on that Ted. Do you have any follow-up that you wanted to explore?

Theodore Joseph Moreau
Barrington Research Associates, Inc.

Q

No, thanks for the clarity on that. Appreciate it. Thank you.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure. Thank you.

Operator: Our next question comes from the line of Paul Silverstein with Cowen. Go ahead.

Paul J. Silverstein
Cowen and Company

Q

Ray, I apologize if you – hey, Ray, I apologize if you all gave this during the call, but can you give us the number of Tier 1 service providers for SBC. And I trust from the commentary it sounds like you now have DICs in this Asia-Pacific Tier-1. Does that mean you now have two Tier-1s out of the gate for Diameter or is it more than that? And I have got a couple of follow-ups.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah, I think it's safe to say that it's those two. I don't want to go beyond that just now, Paul. And then with regard to – we quoted the entire...

Paul J. Silverstein
Cowen and Company

Q

I heard that.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

[indiscernible] (36:47), if you will. Yeah, and it was 22 of the top 50.

Paul J. Silverstein
Cowen and Company

Q

So you have 22 of the top 50 for growth. Does that mean you got two for Diameter, then you have 20 or 22 of the top 50 for SBC by definition?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yes.

Paul J. Silverstein
Cowen and Company

Q

Okay. And so make sure that's in there. All right. And then in terms of your revenue, putting aside the customer number, can you give us a split – and again I apologize if you did during the call, can you give us a split between enterprise and service provider on the SBC piece?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure. If you look at the – if we look at the product revenue, enterprise as a percentage of total process revenue is like 24%. And if you only looked at it on the growth-related product side it's like 27%.

Paul J. Silverstein
Cowen and Company

Q

So its 27% of growth products?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah, yeah.

Paul J. Silverstein
Cowen and Company

Q

Great. And then finally on that – on the 73% coming out of service provider, can you give us a split or at least a rough split between how much of that now is Tier-1s versus non Tier-1s of that service provider piece? I apologize, there's one last question I've got.

Mark T. Greenquist
Chief Financial Officer

A

Approximate, it's at least three quarters Tier-1, I would say.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Well, and it's – yes, so it needs to be and definitely is pretty high, Paul, because – I mean you had a couple of 10% customers this quarter who were very large, and so those two in and of themselves are going to be a significant percentage of that.

Paul J. Silverstein
Cowen and Company

Q

Got it. And you said that each of AT&T and Century were 17, so those two were 34 and then the balance of your Tier 1s was somewhere in the 40'ish, 45 percentage.

Mark T. Greenquist
Chief Financial Officer

A

Yeah [indiscernible] (38:45).

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah.

Paul J. Silverstein
Cowen and Company

Q

All right. Ray, one final question from me. As you look forward in terms of driving your SBC revenue thereby driving your total revenue, those 20, 22 Tier-1s that you're now in with SBC, how many of those have you – be probably the, The Strategic or one or two or three strategic suppliers as opposed to the old days when I think was one-off projects. Is it now most of those 20, 22, where you are either the sole or one of two or three? Can you give us some sense for how many of those?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah. If you open it up to one of two or three Paul, I'd say it's the majority – the vast majority of them. We've gotten very strategic with the majority of those Tier-1s. The virtualization roadmap and our achievements to-date on virtualization has been a big part of that. The fact that in many cases we grew out of the gateway business into an SBC architecture and protected them on their old TDM sites definitely has helped us. So a lot of them got comfortable with us on 9000 and have evolved into 5000, 7000 customers. So that's – I would say we're in a really good position with them and its helping us.

The fact that we grew out of a peering application and now we are starting to proliferate into access also helps because you peer with somebody else, and a lot of times one peering side brings us another peering side as that market evolves. So, all of those I would say were in that bucket.

Paul J. Silverstein
Cowen and Company

Q

And I trust, by definition that's reflected in the Tier-1 for 20, 22s you're SBC'ing. They are coming back to you again and again and again, right, otherwise you wouldn't be one on the strategics.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah, some of them we have just early – penetrated them so I don't want to overstate my – again and again and again or be misunderstood, but yes, I think we are very strategic with these Tier-1s around the world.

Paul J. Silverstein
Cowen and Company

Q

And again, I'm going to apologize for those on the call. One last question. If I took those 20 to 22 Tier-1s, how many of those – to your last statement, how many of those have been secured in the last handful of quarters?

Mark T. Greenquist
Chief Financial Officer

A

Well we said we had seven in the last – we said we had seven in the last five quarters I don't have a number off the top of my head beyond those last five quarters. But that's 7 to 22, Paul; I hope that's enough to give you a sense of [indiscernible] (41:15).

Paul J. Silverstein
Cowen and Company

Q

No, no, that's fine. So, you've gone roughly in the last year from 7 to 22, is that what you are saying?

Mark T. Greenquist
Chief Financial Officer

A

15 to 22.

Paul J. Silverstein
Cowen and Company

Q

15 to 22, excuse me. All right, I'll pass it on. I appreciate it. Thanks guys.

Mark T. Greenquist
Chief Financial Officer

A

Thank you.

Operator: Our next question comes from the line of [ph] Steve Cohen with Provo Partners (41:32). Please go ahead.

Q

Hi, a couple of questions; first, what was the head count as of quarter end?

Mark T. Greenquist
Chief Financial Officer

A

It was about 1,200 people.

Q

1,200? Okay, great. Ray, more strategically, you've made tremendous progress in building the indirect channel and by my numbers it's up – revenue is up, product revenue, more than 50% year-on-year. By contrast the direct revenues I have is roughly flat year-on-year for the nine months of the year. Can you talk a little bit about what's going on the direct sales, which I guess implies sales into service providers and when we might anticipate some acceleration in that business?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure, Steve. Probably the flat side of that business is most likely SBC growth and a little decline on the gateway side. So that side's actually drawn down because it was exclusively – the gateway side was exclusively service provider. So when you look at the mathematics of our top-line, our service provider sector is far more influenced by the legacy businesses trajectory than the enterprise, which is frankly a pure play because there was virtually no gateway business in the enterprise side, okay? So I would assume that as that math changes, it will see some aggregate growth because it's seeing some growth on the growth side now. Makes sense?

Q

Just a follow up.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sorry.

Mark T. Greenquist
Chief Financial Officer

A

Okay. Yeah, go ahead please.

Q

Just to follow up on that is then – if you looked at the carrier business, exclusively the growth products, what kind of year-on-year revenue growth would I expect to see?

Mark T. Greenquist
Chief Financial Officer

A

I don't have that number handy Steve. We may be able to come back to you on that. I don't know – I haven't broken that out per se.

Q

Without getting quantitative, would you expect to see growth in that area?

Mark T. Greenquist
Chief Financial Officer

A

Oh, sure.

Q

Consistent with how the market is growing 30 kind of percent?

Mark T. Greenquist
Chief Financial Officer

A

Yeah, it's in parallel, because as you said the gateway business trajectory on the product side is exclusively on the service provider side. So, as it runs off, it's going to expose what's already a growth business on the service provider side. So we can do the math for you, but I think you can probably do it as well, because all you have to do is burden the service provider side with the entire downward trajectory of the gateway business and let that start to decline.

Q

Great.

Mark T. Greenquist
Chief Financial Officer

A

But our service provider business is growing in line with the market if not slightly above, as is our enterprise side.

Q

Through both channels?

Mark T. Greenquist
Chief Financial Officer

A

Through both the enterprise – yes, the enterprise through the channel and the service provider into the core networks, yes.

Q

Great. Thanks for the explanation.

Mark T. Greenquist
Chief Financial Officer

A

Sure. I had also highlighted – we did on the call – Steve, just for the purposes of everyone else that may or may not have made their early part of the call, the service providers as a channel is a very healthy strategy that's playing out for us right now. We exposed one piece of data, which was AT&T. Business services as a channel was a third of their total business which is why they popped to a 10% customer, or one of the reasons why they popped to a 10% customer again this year – this quarter.

We had another Western-European channel which is a service provider drive a large multinational win in the Lync environment for us. So as the service providers explore SIP trunking and get into that as a hosted or an on-prem solution in either Lync or other environments like BroadCloud, that's a very healthy growth strategy for us as well.

Operator: And we do have one final question that comes from the line of Mike Latimore with Northland Capital Markets. Please go ahead.

Mark T. Greenquist
Chief Financial Officer

A

Yeah, thanks a lot.

Mike Latimore
Northland Capital Markets

Q

Hello. I am curious, on the enterprise side, has your outlook for that segment changed at all; better, worse, same as before?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah, this is Ray. Hi, Mike. I would say same as before; I think the enterprise side is continuing to grow nicely. The good news is it's starting to globalize driven by multinationals. We commented at the front end of my comments that the U.S. is now approximately 20% SIP trunking and that we're seeing good growth, certainly mid-single digit penetrations in Asia-Pac and European region. So, we see some progress in [indiscernible] (46:20) although it's early. And if all of those trends continue, it could be in fact the beginning of a hockey stick so to speak in SIP trunking, and if that's the case the enterprise growth should take off quite nicely in 2015, 2016.

So the trends are in place; they may in fact be accelerating, is how I would summarize where the enterprise is.

Mike Latimore
Northland Capital Markets

Q

And when you talk about enterprise gaining, I think you said 24% of product revenue. That does not include the sell-through in some of these telcos, right, where the telco's actually selling it in to the enterprise – that's excluded from that, is that right?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

That's correct; we score that into the service provider side.

Mike Latimore
Northland Capital Markets
Q

All right. Okay. Do you know roughly how much that would be in terms of additional enterprise revenue?

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

I would say we carved out roughly three – it might be another $5 million, max, of total revenue that you could score both in kind of a hybrid service provider/enterprise side, but we score it on the enterprise side.

Mike Latimore
Northland Capital Markets
Q

Okay. Thank you.

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

Oh! On this – I should say, on the service provider side. Sorry for the confusion.

Mike Latimore
Northland Capital Markets
Q

Right, right. Yeah.

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

Okay. Thanks Mike.

Mike Latimore
Northland Capital Markets
Q

Thanks.

Operator: And gentlemen, we do have a question that was just queued up by Dmitry Netis with William Blair. Please go ahead sir.

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

Hi, Dmitry.

Dmitry G. Netis
William Blair & Co. LLC
Q

Thanks for squeezing me in. I have a couple ones, so I'll go quickly through them, gentlemen. One is – I might have missed it, but can you tell us what the SBC 7000 revenue was this quarter as well as the Diameter revenue this quarter, and then what are you baking in for the fourth quarter for those two product lines?

Mark T. Greenquist
Chief Financial Officer
A

Yeah, so Dmitri, we had talked about the 7000 specifically last quarter because it was the – right out of the gate, but I mean historically we haven't gone into product line details. So I'm not going to give you a specific number, but what I will tell you is that the 7000 continued to perform really well. And certainly as we look at Q4 – and we are looking at the funnel and even as we look out into Q1, and we are looking at the funnel, we've got a very strong – it looks like very strong demand for the new product. So we are very happy with how that's progressing.

And then with regard to Diameter, again I don't want to talk specifically to product lines there, but we currently – we had said basically back when we purchased PT, we thought Diameter would be pretty modest. This year, as we did the product development that we wanted to do as – the original guidance I think was around $3 million and that's where we remain with regard to guidance for Diameter for the year.

Dmitry G. Netis
William Blair & Co. LLC
Q

Okay. All right, thanks. And then as I look into your, kind of the comment made on the enterprise side, which is 24% of your product revenue, can you segment that further for us and maybe tell us what the Lync-related revenue out of that segment would have been?

Mark T. Greenquist
Chief Financial Officer
A

So I don't have a specific number for you, but it's very high. I mean the majority of it would be driven by Lync deployments.

Dmitry G. Netis
William Blair & Co. LLC
Q

The majority of that 24%. Okay.

Mark T. Greenquist
Chief Financial Officer
A

Yeah.

Dmitry G. Netis
William Blair & Co. LLC
Q

Okay. And then a question on AT&T; how much – I know was a 10% customer this quarter. What are you projecting for AT&T in the fourth quarter, given that it's such a big customer of yours? So if you can provide some commentary on that that would be very helpful. And then with the fiscal 2015 – or calendar 2015 rather, what are you thinking there on AT&T, kind of, are they kind of soft in the first half, pick up in the second half, or vice versa? Can you give us some commentary of how AT&T supposedly will project out next year?

And then I don't want to put the words in your mouth, but the $10 million product pushout you had last quarter, can you give us sort of your expectation? Is that still on track, has it pushed out further, is that still sort of what you have been expecting? Thank you.

Mark T. Greenquist
Chief Financial Officer
A

Okay. I'm glad I was writing all those down. So let me take them one at a time. So with regard to AT&T and fourth quarter, I mean actually on the last call, what we had said was frankly we didn't expect AT&T – or at least I didn't expect AT&T was even going to be a 10% customer in the second half of the year. So I was a little surprised in Q3 when they popped up as they did. And as Ray mentioned, a fair amount of that had to do with the strength of the sell-through to enterprise.

So, I'm kind of back to where I was in Q4. I'm not expecting a tremendous amount from them, but we'll have to see with regard to any kind of reselling business, what that does. With regard to 2015, I think you are just asking me to get way ahead of myself with regard to that, so I am going to defer that. And we'll come back in February and when we really talk about annual guidance at that time and talk about the trends that are impacting that, we'll – I guess we'll have more to say on that. So I don't – again, I mean all I wanted – all we really wanted to say was, with regard to Q1 when we look at that consensus out there, we are reasonably comfortable with what we see. And as Ray said, we're committed to our 10 and 10 model.

With regard to the order that we had talked about a quarter or two ago that pushed out, still think that that's a 2015 event. Don't specifically have a specific quarter with regard to and think that's going to be and nor did we ever really say what quarter we thought it was going to be in. I think people perhaps put some words in our mouth, but I don't believe that we ever were calling the ball on that. So we still think that that will happen in 2015, but not exactly sure in which quarter.

Dmitry G. Netis
William Blair & Co. LLC

Q

Okay, I believe Ray did say it was going to be first half I mean if I recall, but that was sort of – was just for the call last quarter. But is that still sort of tracking within your expectations?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah, we still have a great relationship with AT&T Dmitry, and we'll follow their spending pattern. So we feel really good about the strategic projects that we are working on with them.

Dmitry G. Netis
William Blair & Co. LLC

Q

Okay. The last question if I may. On the network equipment manufacturer partnership front, if you could comment Ray, what are you seeing sort of lot of potential clients with the Ericssons, Nokias, Alcatels of the world that they are going through those major sort of architectural deals. Are you working closely with them? Are you trying to sort of collaborate on projects? I mean, give us a state of the market there or the industry there. Thank you.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure. So with regard to all of those partners, our principal goal is to follow the direction of what our core customers want, principally the Tier-1s. Many of those players supply into those Tier-1s with both old and new architectures. And we've been partners with many of them in the past and will continue to be partners with them in the future. But I don't have anything specific on this call to refer to, Dmitry. We'll just continue to work on it. Okay?

Dmitry G. Netis
William Blair & Co. LLC

Q

Very good. Thank you.

Operator: And there are no further questions at this time. I turn the call over back to you, Sir.

Raymond P. Dolan
President, Chief Executive Officer & Director

Thank you very much. I'll be brief in my closing remarks. I know a lot of you need to move on to the market open which is imminent. Thank you very much on behalf of all my colleagues at Sonus for your support out in the marketplace, getting our word out. I'm really pleased with our progress. I look forward to sharing the results for our fourth quarter with you when we close that.

I appreciate your participation today. We've done our best to give you a transparent view into what we see out there and to be as conservative as we think it's appropriate to be with regard to outlook going forward. So thanks a lot. We look forward to meeting many of you in the marketplace over the weeks ahead. Have a great day.

Operator: Ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation and ask that you please disconnect your line. Have a great day everyone.