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Sonus Networks, Inc. (SONS)

Q1 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to the Sonus Networks' First Quarter 2016 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, Wednesday, April 27, 2016.

I would now like to turn the conference over to Mr. Mark Greenquist, Chief Financial Officer. Please go ahead, sir.

Mark T. Greenquist
Chief Financial Officer

Thanks, and good morning, everyone. Welcome to Sonus Networks' first quarter 2016 financial results conference call. Joining me on the call today is Ray Dolan, President and Chief Executive 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 the 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 these documents on our IR website.

As shown on slide two, 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 customer purchasing decisions and revenue recognition, difficulties leveraging market opportunities, and the impact of our cost containment efforts.

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A discussion of these and other factors that may affect 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 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 also included in our press release issued today.

So, with that, let me turn it over to Ray Dolan. Ray?

Raymond P. Dolan

President, Chief Executive Officer & Director

Thank you, Mark, and welcome to everyone on today's call.

Let's turn to slide four for the highlights of the first quarter. I am very pleased to report our first quarter financial results, which exceeded the guidance we provided on our February earnings call in all major areas of performance. We delivered good revenue growth on a year-on-year basis, solid gross margins, strong bookings momentum, and disciplined expense control. All of this led to very solid earnings and cash flow for Q1 and I am very proud of the team for their focus.

When we announced our restructuring in 2015, we established a goal of a breakeven cost structure at quarterly revenue levels of $60 million. We've beaten that goal by a small margin already, and with that restructuring now largely behind us, we should see improved profitability later in the year as quarterly revenue levels increase, assuming our normal seasonal patterns.

We continued to strengthen and deepen our customer relationships and we had two 10% customers in the first quarter, AT&T and Level 3. Our book-to-bill ratio for Q1 was above 1, continuing the strong bookings trends of 2015, where book-to-bill was above 1 for the full year. This gives us increased confidence in our second quarter and our full year 2016 outlook for revenue, earnings, and cash flow.

I am very pleased to maintain or increase our annual guidance, which Mark will discuss shortly, as we build financial and strategic momentum this year. Meanwhile, our balance sheet is stronger year-over-year and we expect it will be even stronger a year from now.

Even with our lowered cost structure, we have continued our multi-year investment in key areas of technology that we believe are most important to our current customers and future prospects. Our technology investments have been focused in key growth areas including NFV, SDN, the shift to cloud-based architectures, and increasingly in the area of network security.

These investment areas have remained our focus for several years. The acquisitions we've done over the past few years in SBCs, signaling and SD-WAN are now combining to form the basis for our technology platform that is increasingly aligned with the trends to securing and enforcing cloud-based architectures.

I will talk more about this in the second half of the call, but for now I'd like to hand it back over to Mark to discuss our financial results and outlook in more detail. Mark?

Mark T. Greenquist

Chief Financial Officer

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Thanks, Ray. As a reminder, gross margin, operating expenses, operating income and earnings 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.

So, now turning to slide six, total revenue of $59.2 million, slightly exceeded our guidance range of $58 million to $59 million. Total product revenue was $34.8 million and total services revenue was $24.4 million in our first quarter. With regard to product revenue, we continue to see strong performance by our flagship SBC 7 K product, which has been extremely well received by our large Tier 1 service provider customers. Our total services revenue were down slightly, $900,000 year-over-year, primarily due to lower professional services revenue. Maintenance, however, was up slightly year-over-year.

First quarter 2016 non-GAAP gross margin was 68.4%, which was almost 200 basis points above our guidance of 66.5%, and 690 basis points better than a year ago. As I just mentioned, our 7K product had a very good quarter and that was the main driver of our strong margin performance.

Our operating cost structure was down by over $5 million this quarter versus a year ago as we had non-GAAP operating expenses of $38 million in the first quarter of 2016 compared to $43.5 million reported in our first quarter of 2015. This reduction in operating expenses was due primarily to the impact of our 2015 cost-reduction initiative and I should mention our head count remained around 1,050 employees during the first quarter of 2016, basically flat from the end of the year.

Our non-GAAP first quarter diluted earnings came in at $0.03 per share, which was well above our guidance of a loss per share of $0.03 to $0.01.

Finally, cash and investments totaled $142.4 million at the end of the first quarter of 2016, which was essentially flat versus the fourth quarter of 2015. We were extremely pleased with our strong cash collections in the first quarter, aided by very good linearity in our first quarter revenue. This led to a significant reduction in our accounts receivable and as such days sales outstanding, which were 52 days in the first quarter of 2016 versus 61 days in the fourth quarter of 2015 and 100 days in the first quarter of 2015.

Now, let's turn to slide seven for a discussion of our second quarter and full year 2016 guidance. Both our backlog and funnel for the second quarter of 2016 are solid and we expect second quarter 2016 revenue to be between $59 million and $60 million. With regard to the full year revenue outlook, we are maintaining our full year 2016 revenue outlook of $255 million to $265 million.

Second quarter non-GAAP gross margin is expected to be 68.5%, which is flat compared to our first quarter of 2016. Non-GAAP operating expenses for the second quarter are expected to be between $38 million and $39 million, and this reflects our expectation that head count will remain relatively flat through Q2, and then will increase modestly in the second half of the year to fund some key strategic initiatives.

Second quarter 2016 non-GAAP diluted earnings per share is expected to range between $0.03 and $0.04 based on 50 million diluted shares outstanding. For the full year 2016, we expect that non-GAAP diluted earnings per share will be between $0.27 and $0.34 based on 50 million diluted shares outstanding.

Let me now turn it back over to Ray for some further remarks. Ray?

Raymond P. Dolan
President, Chief Executive Officer & Director

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Thanks, Mark. Now, I'd like to share some strategic context for our technology investments going forward. The Sonus team has made significant headway in our drive to lead the market to NFV, SDN. We've been focused on evolving our products to software for several years, and I'm pleased to say that all of our major product offerings are now in software.

We have continued our investment in R&D, where it matters most to our customers, and we've been collaborating closely with them throughout this process. We believe we have the right strategy and the relevant product portfolio and roadmap to be the strategic supplier of choice to our customers. This focus on agility and software is more important today than ever given the tremendous confusion regarding the emergence of a new cloud-based service delivery platform.

The transition to software is really about agility. Innovation at the application layer is happening so quickly in the marketplace today that network elements running in dedicated hardware are struggling to keep pace while at the same time creating complex operating challenges that are costly for today's network operators to support. The industry's drive to NFV is really all about increasing the pace of service creation and lowering operating costs.

For both enterprises and service providers, security continues to be an important theme. Sonus has always been in the security business, given that SBCs have always secured the network by protecting networks at their borders against denial and theft of service attacks. Additionally, SBCs protect the privacy of communications by encrypting signaling and media passing through the SBC. Simply stated, SBCs can be thought of as the real-time communications firewall. You'll see us moving to capitalize on this core competency in partnership with others in the data side of the security space throughout 2016.

Specifically, SBCs have an advantage based on where they sit in the communications stack to play a critical orchestration role for security on an end-to-end basis. As our industry continues to evolve towards Unified Communications, we need to unify the security plan. SBCs can provide critical security functions for the real-time side in a similar fashion to the next gen firewall on the data side. Together, these products can collaborate and share context and thereby ensure a secure network connection regardless of the application.

Meanwhile, once all network functions are in software, the entire network stack can be reorganized so it scales in a secured fashion. This is really the drive behind SDN, and increasingly we see that the killer app in SDN is security. Through the interplay with policy and signaling, SBCs can ensure that only authorized users gain access to specific applications and data, regardless of location or modality of access.

Further, Sonus's SDN product, VellOS, provides a programmable topology aware enforcement function for the entire network. Combining the VellOS platform with our SBC portfolio, we can marry session control with network control to provide customers with a complete end-to-end network security. This allows real-time responses to network threats, which is required as security becomes the killer app in SDN.

Whether it's a service provider implementing a private cloud or an enterprise migrating to a cloud-based UCC solution, Sonus is well positioned to meet our customers' needs. We are focused to lead the industry forward to ensure that cloud 2.0 can deliver truly secure resilient real-time communications that are affordable to the mass market and can be delivered profitably by today's service providers and emerging cloud dividers.

In closing, we are very pleased with both our financial results for the first quarter and our outlook for fiscal 2016. We look forward to updating you on our progress in July when we announce our second quarter results. Thank you for your attention this morning and your continued support of Sonus.

This concludes our prepared remarks. Operator, I'd now like to open up the call for the questions.

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QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] One moment, please, for our first question. And our first question comes from the line of Jess Lubert with Wells Fargo Securities. Please proceed with your question.

Jess Lubert
Wells Fargo Securities LLC

Q

Hi, guys. Good morning.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Hey, Jess.

Jess Lubert
Wells Fargo Securities LLC

Q

Can you give us the enterprise and carrier breakdown? I didn't see that in the supplemental. And then I was hoping if you could talk a little bit more about what you're hearing from a customer spending perspective across both of the verticals? And perhaps given the bookings strength, how come you aren't expecting to see a little bit more sequential growth in Q2, given that June period has seen at least mid-single digit improvement in each of the last three years?

Mark T. Greenquist
Chief Financial Officer

A

Yeah. So just with regard to the enterprise, percentage of revenue was 18% in the quarter – of product revenue, 18% of product revenue.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

So, Jeff, I'll talk a little bit about spending trends. I think there is still a tremendous amount of confusion out there, so most of the large service providers' spend is struggling to find an OpEx architecture that really scales nicely. That's why I spent a good bit of my prepared remarks on our drive to software centricity in cloud. I do expect that will probably accelerate either in the back half of this year or next year. We're not calling that. We've actually maintained our guidance for the year just because until we see that we are not going to change that. But for now the spending trends are, most of the large telcos are doing the best they can to really constrain their CapEx until they find that right new architecture.

On the enterprise side, most of their spend is still in traditional nextgen firewall security as well as in WAN proliferation because everybody is moving their software applications and workloads into the cloud. I think that will evolve towards UCC. Again, like the service providers, that will evolve to UCC and SIP-based architectures later this year or into next year. So both of those major spend patterns are, I'd just say, it's steady as she goes right now, but we should see some acceleration over 12 months from now.

So, that's why we're really not calling Q2 any stronger than where we see it. We see our backlog building nicely, we see our bookings momentum building nicely, but the patterns of our seasonal business remain. I hope I've answered your questions there, Jess. I'm happy to take a follow up.

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Jess Lubert
Wells Fargo Securities LLC

Q

Yeah. Just following up on that, I mean it seems like a lot of the strength in the quarter came from the legacy business relative to some of the growth assets. Would the expectation be that legacy remains strong into Q2 as well and we don't really see the uptick in growth products until we get into the second half? How should we be thinking about that dynamic?

Mark T. Greenquist
Chief Financial Officer

A

Yeah. I am not sure that I agree with the contention that the strength was in the legacy products. I mean, in Q1, the total legacy revenue was just over $22 million. The growth-related revenue in total was just shy of $37 million, so from a year ago, virtually all of the growth. I mean, legacy was up maybe $1 million versus a year ago, the rest of the revenue growth from a year ago was all growth-related product. And much of that was dominated by the 7K, as we mentioned. It had a very good quarter. In fact, even versus the fourth quarter, the 7K was up a touch sequentially despite total revenue being down considerably from the fourth quarter of 2015.

So, that was the main driver of results, continued strength in the 7K. Like I said, being up just a touch from the fourth quarter, being up considerably versus a year ago and providing extremely good product mix with regard to gross margin. I mean, that's essentially also what drove the overage in gross margin versus what we had guided back in February.

Jess Lubert
Wells Fargo Securities LLC

Q

Helpful. Maybe if I can just squeeze one more in. Can you share any information with us at this point in time as to what percentage of the product revenue is coming from virtual, where you think that might be as we look out 12 months, 18 months, 24 months from now?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah. Jeff, this is Ray. Good question. It's still very small when you're talking about just purely a virtual instance set up in somebody's cloud architecture on bare metal. I think the industry is still at least a good year from evolving to that model, but everyone considers that to be table stakes to drive fundamental architectural decisions, and most large spenders are in architectural discussions with us and other players.

However, I will say that since we are ready for that, our fundamental designs are largely software content sitting on optimized hardware. It's true of our 1K, 2K, it's true of our 5K, and it's true of our 7K. And I think you can see that in our fundamental margin progress that we've made over the last several years. We are still selling a great deal of software. It's just right now sold on optimized hardware. It's going to be a little while. People are not just going to move their network functions to software. They're going to reorganize the stack before they reestablish a pure virtual growth strategy, and I think that's still a good 12 months away. It's possible that it's even further out. I hope that's a helpful response to your question, Jeff. Okay?

Jess Lubert
Wells Fargo Securities LLC

Q

Thanks, guys.

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Raymond P. Dolan
President, Chief Executive Officer & Director

A

Thank you.

Operator: Our next question comes from the line of Dmitry Netis with William Blair. Please proceed with your...

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Hey, Dmitry.

Dmitry G. Netis
William Blair & Co. LLC

Q

Thank you. Good morning, gentleman. Nice results here in Q1.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Thanks.

Dmitry G. Netis
William Blair & Co. LLC

Q

I wanted to follow-up on the competitive environment a little bit and see what you're seeing out there with regard to Oracle, maybe Alcatel-Lucent now being acquired by Nokia. Is competitive environment easing at all? Do you see Oracle maybe stepping on the gas a little bit more now that they are getting their act together under a new management team there? So anything you can talk to as far as the competitive environment for the growth product set would be a great help? And then I have a couple of follow-ups.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure, Dmitry, it's Ray. I'll take them in two stages. Nokia, Alcatel-Lucent, I don't see any change and I don't expect to see much of a change there. With regard to Oracle and their acquisition of Acme and Tekelec, there has been some confusion. I don't believe they're as focused as we are on this space, and I believe that confusion is going to continue. I don't see it to be meaningfully different this quarter from last quarter. I don't expect it to change much over the next, say, six months. But we are going full bore after the virtualization of the entire cloud software stack, and I like our odds. So I don't see much competition change there from either side.

Dmitry G. Netis
William Blair & Co. LLC

Q

Okay. And then as I look at the supplemental, Level 3 popped up as a 10% customer. I haven't seen them as a 10% since probably 2012. Can you discuss a little bit what their strategy is? Or what exactly they are trying to build out? Is this a long-term project that they are implementing? Do you have visibility of that business for the next couple of quarters? Is this just a one-time event that they just need to reorder to kind of patch their network or anything you can talk to that customer would be great? I understand that you may not want to provide too much detail, but just curious to see why they popped up as a 10%?

And then the couple of deals you had on the SS7 side in Asia, I was just wondering what the progress of those are and whether you're going to see them in the back half of the year?

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Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah. So thanks, Dmitry. On Level 3, happy to talk about it. We are limited by the customers what we can say as most large spenders ask us not to talk too much about their strategy. But Level 3 has been one of our largest customers for at least a decade. And this is just a continuation of their network build-out and continuation of our relationship with them. It's larger than, say, normal order, but we continue to have a good relationship with Level 3. So I can't really talk too much about the content behind that.

With regard to the SS7 deals, we are continuing to make progress in Asia. We're also continuing to make progress all around the world with regard to signaling. We are making some nice progress in [indiscernible] (23:34) as well, and I expect that to continue throughout the balance of this year.

Dmitry G. Netis
William Blair & Co. LLC

Q

Ray, anything on the Diameter side? I know that's been a bit of a struggle. Have you seen any improvement there, any new deals coming in?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

No, there's not much to talk about on Diameter yet, Dmitry. We are still in the mode of – our signaling business is still in the mode of getting design wins into SS7 based on the ability to port folks over easily to Diameter. But I do believe that – while I'd love to be able to talk about more Diameter wins, because it probably would be sexier from the standpoint of perceived value for some folks on this call, those are really nice design wins, and there's a long leg on the SS7 side of this business that we should be able to monetize for quite some time.

Dmitry G. Netis
William Blair & Co. LLC

Q

Okay. And then maybe last one, if I could, as far as the, if you take your product revenue now, whichever way you want to slice it or dice it, but if you took your, let's say, gross product revenue, how much is 7K? I know you gave some indication last quarter. I'm guessing that's probably improving, but is it half of that product revenue now?

Mark T. Greenquist
Chief Financial Officer

A

I would say...

Dmitry G. Netis
William Blair & Co. LLC

Q

It was a third last quarter. Yeah. Go ahead.

Mark T. Greenquist
Chief Financial Officer

A

No, of the total product revenue, it's probably getting close to be a third of it, not quite there. I mean like we said last call, the 7K was in the fourth quarter just over $10 million, and that was the same thing in the first quarter. So, not quite a third of the total product revenue, but it's starting to get pretty close.

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Dmitry G. Netis
William Blair & Co. LLC Q

Very good. Thank you very much for that; appreciate it. Keep up the good work.

Mark T. Greenquist
Chief Financial Officer A

Thanks, Dmitry. Thanks.

Operator: Our next question comes from the line of Ryan Hutchinson with Guggenheim. Please proceed with your question.

Ryan Hutchinson
Guggenheim Securities LLC Q

Hey, good morning, guys.

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

Hey, Ryan.

Ryan Hutchinson
Guggenheim Securities LLC Q

So a couple of questions. Hey. So first on clarification, I think you guys just said that the growth was $37 million and legacy $22 million; what was the split? I think you gave it on the last call. What was SBC product or growth related product revenue?

Mark T. Greenquist
Chief Financial Officer A

It was close to $25 million. It was like $24.8 million.

Ryan Hutchinson
Guggenheim Securities LLC Q

$24.8 million. Okay. All right.

Mark T. Greenquist
Chief Financial Officer A

And the legacy product was just under $10 million.

Ryan Hutchinson
Guggenheim Securities LLC Q

Just under $10 million, okay, great. All right. And then, Ray, you touched on it in your prepared remarks on potential partnerships in 2016, specifically on the security side. Maybe could you expand on that and when do you think that could materialize and then how that could change your go-to-market, potentially?

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Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure, Hutch. So what I am trying to talk about now so that we can build momentum, if you will, into the future, I'm probably going to stop short of naming names, but I'm happy to talk about this structurally, is we've spent several years evolving from first from gateway to SBC to our hybrid product. Then we built some standalone SBCs, so we've got tremendous traction there, and we've moved into software and we've improved our margin and the company's really well positioned. But basically we still are and are perceived to be a SIP-based player, a voice-based player, a telco-based player.

Yes, we've made reasonable penetration into the enterprise, not enough, but we are pushing as hard as we can. And now that we're in software, we are starting to align with what I believe is a very, very big trend, and by the end of the year should be – where we should be in partnership with companies and talking about it.

But it is the following; is that in order to unify communications, you've got to unify security, and right now there are two edges to the network, there's the real-time SIP-based edge of the network and there is the next-gen firewall edge of the network and neither sees both sides, but both, in software instances, can become part of a new cloud architecture.

Now if we are right, you should see us partnered with next-gen firewall companies that want to, in fact, make themselves into application aware and including SIP-based application aware, so that there is, in fact, just one edge to the entire cloud architecture. [ph] That's what the vision they sell (27:50), but they are not able to deliver that. So that's where we are going. Now whether or not it changes our go-to-market strategy, I actually think it has the potential to have a profound effect, but we are short of calling that ball.

What it would look like is, if we could be a software instance, securing the edge of the SIP side of the network and sharing context with the next-gen firewall, then we should become part of the security market that tends to go-to-market through channels. Or we would just be part of a product offering that gets sold direct into the service provider side by those security players. So that's the direction we are taking. It's taken us years to get ready for that, we're spending a great deal of our energy around that. And I actually think it's what service providers and enterprises need because if you think about it from the service provider point of view, there's a great deal of concern that if they evolve from traditional telco architectures and move into a very open architecture, a lot of things breakdown. You may or may not have seen fairly high profile exposure of something as signaling, as simple as old SS7 signaling networks and how easy they can be to hack if in fact you don't put a firewall application inside of old signaling architectures.

And of course, the security industry is on fire as an investment thesis in the enterprise side of the business, but I don't think that's sustainable, because it's just taking, is crowding out additional CapEx that people need in order to build out cloud-based architecture. So there has to be some rationalization of that, and we hope to be – we believe we are qualified, and we hope to be a major player in that rationalization. I hope that's helpful. That's as much color as I can probably give you at this point in time. But I'm very excited about the thesis.

Ryan Hutchinson
Guggenheim Securities LLC

Q

Okay. Great. I appreciate the color.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Anything else we can help you with, Ryan? Okay, thanks. Go ahead.

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Operator: Our next question comes from the line of Greg Mesniaeff with Drexel Hamilton. Please proceed with your question.

Greg Mesniaeff
Drexel Hamilton LLC
Q

Yes. Thanks, good morning. A couple of things I wanted to ask you. First, Ray, in the call today, you mentioned that you pretty much have a software-only version of every product family or every product that you sell, and I am curious what the take rate on the software-only version of each product family is at this point, and how it's trending?

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

Okay, so, Greg, I did say major products, because we didn't turn our old iron gateway into a software-based product [indiscernible] (30:24) there.

Greg Mesniaeff
Drexel Hamilton LLC
Q

Right, right.

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

But when it comes to all of our SBCs and our signaling architecture, from the core or the edge of the network, we've evolved that into software-only. Also, I think this is part of Jess's prior question, so I'm happy to clarify it again, but I don't want to be repetitive. Very little of the market is in a software-only bare metal uptake. I mean, we've spun up in virtually all of the cloud environments and there have been a small number of customers that have turned up small instances, and for example in Amazon Cloud environment, but they are not meaningful to move the revenue needle for us yet. There are good indications of the technical viability and the commercial viability of spinning up our session layer, and enforcing an end-to-end network layer across an enterprise. But the majority of our sales, and I believe this is true for the rest of the industry. But I can speak for Sonus, the majority of our sales are in hardware right now, and probably will be for 12 months, and potentially longer.

But I simply want to provide some context. I'm okay with that being the case given that we are continuing to make margin improvement at a major goal here. And so to the extent that we can drive to and through 70-point gross margin quarters towards the back end of this year as we did last year, I'm comfortable with the industry buying software-only and I'm also comfortable with the industry buying from us on a hardware basis as well.

Greg Mesniaeff
Drexel Hamilton LLC
Q

Sure, but I guess you could foresee at some point that there could be a significant shift in that model where it's really the software that people are going to be starting to buy, right?

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

Yes, it's hard to call the timing on that, but when it happens, we'll all look back and say it was obvious. What I believe will need to happen is that all of the network functions that these operators use are all going to have to

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move into software. When they are, they're going to have to realign the stack, and when they realign the stack, that's really what SDN is all about. I think SDN in its full form is at least 12 months from now, if not further.

In my prepared remarks what I tried to indicate is that I believe the orchestration layer of SDN is going to be the security layer and that the rest of the network functions are going to enforce the decisions made by that security layer. And I think that's going to take a while for people to migrate to, and adopt to, but I think it will have profound impacts on networks going forward.

Greg Mesniaeff
Drexel Hamilton LLC

Q

Got you, Ray. Thanks, that's very helpful. Just one quick follow-up. In the Q&A, it came out that your enterprise revenue split was about 18%. I was just curious if you can give us a little more color as to what type of enterprise customers you are talking about? I assume it's the larger ones? And as a part two of that question, any efforts to kind of target the lower end of the enterprise market like some of your competitors are doing? Thanks.

Mark T. Greenquist
Chief Financial Officer

A

Sure, Greg. Yes, you're correct that the majority of our results in the enterprise side are with large spenders. That would make sense, because we are evolving from, if you will, a telco architecture into the enterprise, and we've had some very strong success with large industry verticals that run very, very large communications networks. We also do go after the low end or less dense, if you will, smaller side of the marketplace. We do that predominantly through the channel in our linked relationship with Microsoft, and it's maintained a healthy footprint in our enterprise play as well. But we'll probably evolve more towards that in the future.

Greg Mesniaeff
Drexel Hamilton LLC

Q

Thank you.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Thanks, Greg.

Operator: Our next question comes from the line of Mike Latimore with Northland Capital. Please proceed with your question.

Q

Yes, hi, this is [ph] Vijay Devar (34:17) for Mike Latimore.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Hey, how are you doing?

Q

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Good. A couple of quick questions. I guess obviously you can't talk much about the Verizon project, but if you could give us [ph] some insight of (34:31) how this is progressing and was there any impact from, I mean do you see impact from the recent Verizon strike that could potentially impact your second quarter or the full year revenues?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah, I don't see any impact at this stage for the Verizon strike on our business.

Q

Okay. If you look at the pipeline opportunities currently and versus the previous quarter, do you see any incremental improvement in the pipeline or is this kind of flat? How do we read about it?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Well, I think we expect the pipeline to continue to be pretty solid. I mean, as we said in our remarks and that reflects our view that revenue is going to grow sequentially as we go into the back half of the year. So I wouldn't say that there's like major changes that we see from February. I think what we're seeing are things, kind of fall into line consistently with what we had expected. And that's why we think revenue in the second quarter is going to be pretty consistent versus what we were talking about in February. And revenue in the second half of the year we think is going to be consistent versus what we were talking about in February.

Q

Right. And finally, do you expect the 7K revenues to kind of grow sequentially for the next few quarters? Or do you see some flattening over time?

Mark T. Greenquist
Chief Financial Officer

A

So I think the 7K is going to continue to be strong. I mean, I don't know that they're going to grow sequentially. We had a very good first quarter. That would have been the one thing that, if I was going to say that was surprising to me, I didn't think that we were going to have a strong product mix even with the 7K. So that was great that that happened, and I think it continues to show that for any kind of customer out there who is looking for a high performance SBC, especially large service providers, the 7K seems to be essentially running everybody else over in that segment of the market.

So I think we're going to have continued success with that product, but it is a large service provider product, so the revenue is going to tend to be lumpy. But I think when we look back over the course of 2016, we're going to see that that product performed extremely well and was a big driver to not only growth, but improved margin over the course of the year.

Q

Yes, thank you. Thanks a lot.

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Operator: Our next question comes from the line of [ph] Steven Cohen with Provo Partners (37:17). Please proceed with your question.

Q

Hi, good morning. Two questions. First on Level 3 and AT&T, can you give us some sizing of what the revenue contribution was in the quarter? And then second question, shifting to the margin, which clearly the strong gross margins have been kind of recurring story over the last few quarters, and Ray, you commented, you expect to see that back into the 70%s in the back half of the year. Just trying to get an idea of what you think steady state in that particular business could turn out to be? I mean could gross margins get as high as 75% down the road?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Mark, you go ahead and take the first question, I'll take the second.

Mark T. Greenquist
Chief Financial Officer

A

Yeah, on Level 3 and AT&T, I don't have the exact percentages right offhand; they're going to be in the 10-Q, which we're going to file, if not later this week, then early next week. I want to say that Level 3 was – I'm thinking it was about 14%, although again, I might be off on that number. And then I think AT&T was just over 10%, like something like 11% or so. But, [ph] Steve (38:30), those exact numbers are going to be in the 10-Q, and we're going to file that over the next few days.

Q

Thanks.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Okay, [ph] Steve (38:38), with regard to long-term opportunity on margin, I would not expect in 2016 to see numbers like you quoted at 75% gross margins. But as to the future beyond like 2017, 2018, 2019, as the industry moves towards software, I don't see really any reason why we couldn't go to that and perhaps beyond. It really will depend on how fast the industry moves to a software-based architecture, what our channel strategy involves towards. But I am very pleased that when I walked into the company six years ago, we were basically varying around a high 50%s gross margin with the perception that that was the long-term margin trajectory of the company.

And as we've evolved from a gateway to an SBC company and towards a software-based architecture for the cloud, we have methodically moved through the 50%s into the 60%s, and now from the 60%s with an opportunity to touch the 70%s. And we did that late last year. I do expect we could do that again at the end of this year if we drive the seasonal patterns that we saw last year. And so I'm really pleased with our margin progress. Because for us to drive to profitability, we've got to get to gross margin first, we can't just shrink our OpEx footprint.

So I'm very pleased with the profitability in the first quarter, albeit off of a small revenue number like $59 million. But as we start to see the seasonal patterns of our business evolve, which we're going to do everything we can to drive to, we should see increased profitability going forward in the back half of the year. Okay?

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Mark T. Greenquist
Chief Financial Officer

A

Hey, [ph] Steve (40:10), it's Mark again. While Ray was talking I actually looked up in the draft 10-Q what the numbers are going to be. So for AT&T I was right, it's 11%. But for Level 3, I was a little low, it's actually 19%, as opposed to what I just told you, 14%. So 19% for Level 3, and 11% for AT&T.

Q

Thanks a lot [ph] for that (40:33).

Mark T. Greenquist
Chief Financial Officer

A

Yep.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Thanks, [ph] Steve (40:35).

Operator: And Mr. Greenquist, there are no further questions at this time. I'll turn the call back to you. Please continue with your closing remarks.

Raymond P. Dolan
President, Chief Executive Officer & Director

Okay, everyone, this is actually Ray Dolan. Thank you very much for your time. Have a great day, and we look forward to speaking with you between now and July. And of course, we'll all be back on the call in July announcing our second quarter. 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 lines.

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