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DZSI - Q2 2019 DASAN Zhone Solutions Inc Earnings Call

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## CORPORATE PARTICIPANTS

**Il Yung Kim** *DASAN Zhone Solutions, Inc. - CEO, President & Director*

**Mikhail Golomb** *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

**Pei-Hua Hung** *DASAN Zhone Solutions, Inc. - VP of Finance & IR*

## CONFERENCE CALL PARTICIPANTS

**Christian David Schwab** *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

**Jon Deroy Gruber** *Gruber & McBaine Capital Management, LLC - Co-Founder, Principal, and Manager*

**Ku Kang B.** *Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

**Timothy Paul Savageaux** *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

## PRESENTATION

### Operator

Good day, ladies and gentlemen, and welcome to the DASAN Zhone Solutions Q2 2019 Earnings Conference Call. (Operator Instructions) As a reminder, this call is being recorded. It is now my pleasure to introduce VP of Finance and Investor Relations, Pei Hung.

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### Pei-Hua Hung - *DASAN Zhone Solutions, Inc. - VP of Finance & IR*

Thank you, operator, and good afternoon, everyone. Thank you for joining us on our second quarter 2019 earnings call. Joining me on the call today are Yung Kim, Chief Executive Officer; and Mikhail Golomb, Chief Financial Officer. DZS issued a press release this afternoon announcing the results for its second quarter 2019. You can access the press release online in the Investor Relations section of the company's website, investor-dzsi.com. During the course of this call, we will refer to forward-looking statements based on our current expectations. These statements are subject to risks and uncertainties. Factors that could cause actual results to differ are detailed in our 8-K filed today and in our other SEC filings. The company undertakes no obligations to update or revise any forward-looking statements.

Please also note that certain financial measures we use on this call are expressed on a non-GAAP basis. We have provided reconciliations to these non-GAAP financial measures to GAAP financial measures in our earnings press release. With those comments in mind, I'll now hand over the call to Yung. Yung?

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### Il Yung Kim - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Thank you, Pei, and good afternoon, everyone. Our second quarter continued on the same strong trajectory as our Q1, with revenue of \$83.7 million, coming in line against our guidance of \$82.5 million to \$86 million. We saw strength broadly across our Asia Pacific and Middle East regions. And to keep some perspective, 6 of our top 10 customers came from the Middle East, Japan and Taiwan in this quarter. We did not have the same level of contribution from India in the quarter, given their month-long elections, only just the rough half, at the end of May, but we expect the same aggressive investment trajectory for broadband penetration in the country and would expect activities to significantly come in India, particularly in Q4 of this year.

Given some of the geopolitical headlines, let me spend some time to give you our perspectives for our business. It is important to remember that we are a U.S. company based in Oakland, California, and with manufacturing capabilities in the U.S. as well as in Europe and globally. As such, we have not seen and do not expect negative impact from geopolitical headwinds in the Asia Pacific region. In fact, we believe we can accelerate our efforts, particularly in Japan, given the country's move away from Chinese suppliers for their 5G network buildout. We continue to see strong momentum in Japan, where we have 2 of our top 10 customers in the Q2 quarter.



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In addition, we recently won a contract with a top tier carrier in Japan for 5G mobile transport. We are excited about this "multi-tens of million dollar opportunity" over the next 3 years. We believe there is room for further revenue upside from higher unit volumes as well as from multi-year extension. In fact, we would characterize this contract as being more significant than the existing 5G commercial contract we have from current revenue and the future revenue potential prospective. We have a strong, longstanding commercial relationship with this carrier, and we play an instrumental role in their 4G LTE deployment in the last cycle. We are pleased, we can continue to play a key role in the rollout of their 5G network.

Additionally, we are focused on other 5G opportunities in Japan. We recently signed a letter of intent to be a technology partner to provide innovative 5G mobile anyhaul solution with another Tier 1 carrier in Japan. We expect to share further news of this partnership in the coming weeks. We are also extremely pleased with the progress we have made in Korea on our 5G growth initiative. On August 1, we announced our second commercial 5G contract in South Korea with Korea Telecom, and the press release is available on DZS investor website. Since 5G became available in South Korea, in spring of this year, the country has recorded the fastest 5G adoption in the world, so far with subscribers exceeding 1 million in the 3 months since the launch. In fact, South Korea is currently considered one of the largest 5G market in terms of coverage and usage. To close out on 5G opportunity, we strongly believe that when carriers start to upgrade their optical systems, we would be well positioned to be awarded additional 5G spend, given our fiber-first lineage, our global customer diversification and our global presence.

On the FiberLAN initiative, we are already seeing some early successes since we launched our plug-and-play turnkey solution to the enterprise market at the end of January. In Q2, we won a large FiberLAN contract in the middle-single-digit million with a noncarrier customer in the Middle East. Looking forward, we have solidified a number of key reseller relationships in North America, and we are progressing towards finalizing strategic partnerships in Europe in the second half of 2019. We are also looking strategically at the Middle East and Asia market.

I also wanted to provide you an update on our School-Net win that we announced in February. As a refresher, we were elected by the South Korea Ministry of Education to provide SDN-based network management solutions to connect more than 11,000 schools across the country over the next few years. We have now deployed our software management system across more than 20 schools and are finding opportunities to bundle our switches as part of the network upgrade. We expect full software and hardware revenue to accelerate as we connect more schools. On the growth and access front, we are encouraged by the continued secular move from copper to fiber, particularly in historically copper-rich regions, like the U.S. and Europe. One of the strongest signals to us are that at least 2 of these Tier 1 carriers in the U.S. recently announced their intent to build significant fiber network after they have historically invested in copper-rich infrastructures. As the acceleration of fiber-based on GPON continues, we will be well positioned given our fiber-rich heritage and the fact that DZS is one of the pioneers of a fiber-based broadband access technology. In the interim, we have leading G.fast solutions, which we acquired with KEYMILE to help reach the gap from copper to fiber.

We're a management's team that strives to execute on what we said we would do. So I'm pleased to report that we once again met our revenue, gross margin, guidance, during the second quarter and significantly outperformed our guidance on adjusted operating expenses and adjusted EBITDA.

Now I'd like to spend a little bit of time on our full year outlook for 2019, which Mikhail will continue to go into more detail later in his remarks. After a review of our opportunities, for the rest of the year, particularly in broadband access, we have decided to slightly lower our full year 2019 revenue forecast range to \$345 million to \$355 million from our prior guidance of \$350 million to \$360 million. We are also tightening our gross margin range to 32.5% to 33.5% from our prior guidance of 32.5% to 34%. The revised guidance outlook was driven by 2 things: the first was a single-digit million impact from a large carrier in Europe that has publicly stated it was pausing its CapEx plan for the rest of 2019. This has impacted our German business, although not in the same magnitude as it has impacted our peers, given our revenue diversification. The second impact was from India. We were hopeful that post-elections, business would ramp up in earnest in Q3, but the pace has been a bit slower than we had expected, and we see business activities resuming in Q4. That being said, we are increasing our full year adjusted EBITDA guidance to a range of \$19 million to \$22 million from our prior guidance of \$17 million to \$20 million.

I'll now turn it over to Mikhail to discuss our Q2 results and the full year outlook in greater detail, but I wanted to provide this color to let you know that we are strongly committed to continue delivering our growth strategy to profitably scale the business. Mikhail?



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**Mikhail Golomb** - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

Thank you, Yung. I'll start by discussing our second quarter results and end with some color on our outlook.

Second quarter revenue of \$83.7 million was in line with our guidance of \$82.5 to \$86 million and grew 10% year-over-year against a somewhat difficult comparison from Q2 in 2018, where we benefited from a significant \$16.5 million contract from an Indian customer. As Yung discussed, we think the Indian business reaccelerates in Q4 of this year. From a customer perspective, LG Uplus represented a 12% customer in this quarter, with no other single customer accounting for more than 7% of revenue as we continue to enjoy a very diversified customer base. In terms of market segmentation of our revenue, we saw strength in our Asia Pacific, Europe and Middle East markets. Asia Pacific, including Korea, represented approximately \$42 million or 50% of total revenue. Within Asia Pacific, we saw momentum from Japan where we have 2 of our top 10 customers as well as from Taiwan and Korea. The EMEA region represented approximately \$25 million or 30% of our total revenue. In this quarter, we counted 3 Middle East customers in our top-10 customer list. This includes the Tier 1 carrier that we spoke about on our last earnings call that contributed strong single-digit millions in backlog.

It also included a sizable FiberLAN win with a noncarrier customer. The North American market remains flat at approximately \$11 million or 13% of our total revenue. This appears to be in line with what our peers have said of our CapEx level with U.S. Tier 2 carriers. And last, but not least, the Latin American market contributes approximately \$6 million or 7% of the total revenue.

Now turning to the gross margins. GAAP gross margin for Q2 2019 of 32.2% came in line with our guidance range of 32.5% to 33.5% and came favorably against Q2 2018's gross margin of 38.4% and was approximately same as in Q1 2019 when it was at 33.6%. The favorable year-over-year comparison reflects an unusually large revenue contribution from India in the prior year period. In the quarter, our GAAP operating expenses were \$24.8 million. Our non-GAAP adjusted operating expenses of \$23.3 million came in better than our guidance range of \$24.5 million to \$26 million. We generated positive adjusted EBITDA of \$6.7 million or 8% margins against our previous guidance of adjusted EBITDA between \$2 million and \$3 million. We are very pleased with a significant outperformance on adjusted EBITDA and attribute this beat to our tight cost controls this quarter, particularly around headcount management and discretionary spend. The difference between reported GAAP and non-GAAP results in this quarter includes stock-based compensation, depreciation and amortization expenses and noncash step-up in fair value amortization of acquired inventory of approximately \$201,000. Our GAAP net income attributed to DZS for Q2 2019 totaled \$2.4 million or 13% per diluted share. We benefited from a positive foreign currency gain of \$1.6 million this quarter. Our non-GAAP net income attributed to this year's Q2 2019 totaled \$4.8 million or \$0.26 per diluted share. Once again, we are pleased to deliver this record high earnings per share through our shareholders this quarter.

Now looking ahead to this third quarter 2019. We expect revenue of between \$88 million and \$94 million or an expected growth of approximately 22% to 31% year-over-year from Q3 2018. We expect Q3 2019 GAAP gross margin of 32.5% to 33.5%. We expect Q3 2019 non-GAAP adjusted operating expenses to be between \$24.5 million and \$25.5 million. Of note, this reflects continued cost control and operating leverage with non-GAAP operating expenses staying around 27% to 28% of revenue, in spite of incremental R&D spend in the second half of 2019 related to accelerating of our 5G projects. We expect Q3 2019 non-GAAP adjusted EBITDA to be between approximately \$4 million and \$6 million or approximately 4.5% to 6% margins.

As Yung discussed earlier, we're slightly lowering our full year 2019 revenue and gross margin outlook, but yet increasing adjusted EBITDA guidance. We expect full year 2019 revenue of between \$345 million and \$355 million versus prior guidance of \$350 million and \$360 million, which reflects revised year-over-year revenue growth of between 22% to 26%. We expect full year 2019 GAAP gross margin of 32.5% to 33.5% from our prior guidance of 32.5% to 34%. We are committed to delivering on our profitability guidance, and as such, we are lowering our full year 2019 non-GAAP adjusted operating expenses to \$96.5 million to \$99.5 million from our prior guidance of \$97 million to \$102 million. We are also increasing our full year 2019 adjusted EBITDA guidance to a range of \$19 million to \$22 million or approximately 5.5% to 6% of our total revenue from our prior guidance of \$17 million to \$20 million. At this point, let me turn the call back to Yung.

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Thank you, Mikhail. To wrap up, we were pleased to execute to a strong second quarter, with the company beating guidance significantly on adjusted EBITDA and generating a record high net income and earnings per share for our investors. For the full year 2019, we are committed to

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delivering on the guided profitability and to continue to deliver shareholder value. We see significant business momentum, particularly related to 5G opportunities in Japan and Korea each of these 5G commercial contracts that we have won, including with the 2 Tier 1 carriers in Korea and with a Tier 1 carrier in Japan of multi-tens of million dollar opportunities for us for the next several years. We're also extremely excited to partner with a Tier 1 carrier in Japan to deliver innovative 5G anyhaul solution. We believe that 5G-related revenue will take shape, in earnest, in the first half of 2020 and drive accelerated organic growth for us. We are also focused on growing our enterprise segment with the FiberLAN, accelerating the deployment of our SDN solutions and to further penetrate in emerging markets, like India.

Operator, we are now ready for Q&A.

## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) And our first question comes from the line of Christian Schwab with Craig-Hallum.

**Christian David Schwab** - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Yung, can you give us some further clarity on the 5G opportunities with Japan? You talked about opportunities within that country as customers move away from Chinese suppliers and their 5G network buildout. My question is, one, is the reason when that you did announce the 2 customers that you're shipping to meaningfully, is that at the expense of Chinese suppliers already? Or are their share of wallet opportunities with those customers or opportunities at new customers? Just trying to gauge the potential magnitude of that.

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Okay. One customer that we signed the contract has been our customer for nearly 10 years, and they are replacing a Chinese vendor, and specially with 5G they are launching next year. This is an opportunity to put the 5G infrastructure for the backhaul and transport layer for them. So the other one, which we can name, that we have a letter of intent, is Rakuten that they're choosing us as sole anyhaul, which means fronthaul or backhaul. We have not got orders yet, but we have letter of intent. So we can -- so the contract is with a Softbank that we signed. The actual contract is in our pocket. We are already developing it, and we have workshops, technical specs are finalized. So those systems are going to be delivered early 2020.

**Christian David Schwab** - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay. If -- you talked about India being -- seen a significant pick up in business in Q4. Is there any geographies that you would expect for business momentum to be down Q3 to Q4 when you look at the back half of the year? Or right now, you would just expect India to come back and everybody else to spend as kind of as advertised?

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

I think that Andhra Pradesh is the province or the state that's our main customer. You know that there were 2 vendors supplying to them. And 1 of those 2 was us. The government has not appointed the board members of the -- they call it APSFL, which is Andhra Pradesh State Fiber Network Limited (sic) [Andhra Pradesh State FiberNet Limited]. And once those board members are in position, I think, they will start executing the roll out again. But it's a lot later than I thought those members will be appointed by -- within a month of election finishing, which is June. They have not done yet. I think, what I heard, lately, is it will be soon appointed, and so we expect the business to pick up in Q4 instead of Q3, which we thought. And the other state is adjacent state called Telangana. And Telangana has slightly different business model that they have set up a state-owned company to do it. But Telangana is much more trying to get more subsidy from the central government. And after elections, I think it's going to



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take a little longer than -- we have been working with them. We have MoU signed, and we have our equipments in their lab. I think we strongly believe once they start pushing out, we will be one of the key vendor.

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**Christian David Schwab** - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay. Great. And my last question, Yung, as to your comments on broadband access front and increased fiber initiatives by U.S. carriers, is that -- do you believe that you'll be able to have a stronger presence going forward in The United States spending there?

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**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Yes, in fact, we've been invited to go for the RFP response to one of the top customers in U.S. with fiber opportunity. And so I think we are seen as one of the strong competitor in the U.S. market. I think -- I hope that's the beginning of many other opportunities in the U.S.

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**Operator**

And our next question comes from the line of Dave Kang with B. Riley.

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**Ku Kang** - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

My first question is, just can you give us an update on FiberLAN 2.0? Are you still targeting \$25 million for next year and that contract, Middle East customer, is that FiberLAN on FiberLAN 2.0?

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**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

It is FiberLAN because of a sheer size of the roll out. It's a huge campus, and it's not a carrier customer. And they will have similar software as the FiberLAN 2.0 that our learnings from developing FiberLAN 2.0 will inevitably include some of the features, but because of the cache size that we have to roll out FiberLAN 1.0.

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**Ku Kang** - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

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Okay. And then first my first question about still targeting \$25 million next year for FiberLAN 2.0?

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**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Yes, I think that we are signing a number of -- or at least (inaudible) resellers and distribution in U.S. -- and in fact, I have a big meeting towards end of this week coming from one of the biggest distributors. So there is a strong interest. I think the whole industry has this FiberLAN using GPON for the indoor is picking up now.

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**Ku Kang** - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Got it. And then you mentioned 2 Tier 1 U.S. carriers sending strong signals about transitioning from copper to fiber. Are they your customers?



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**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

No. I think they're not our customers. We, in fact, have -- one of the biggest Tier 2 customer has asked us to reply to their RFP.

**Ku Kang** - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Got it. And then on this large European carrier, I think that was one of the reasons for revising your outlook for this year. Is that ET? I thought they were pretty small customer.

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

I mentioned, yes, I mentioned that our U.S. competitor has measured the same customer, in fact, yes.

**Ku Kang** - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Okay. All right. I guess, my last question is.

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Our customer is not as big as our competitors.

**Mikhail Golomb** - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

It's a very lower-digit million, very, very low. Just to give you a sense.

**Ku Kang** - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Got it. And then, obviously, Huawei are struggling not just in the Chinese market but also I'm hearing even the European and other international customers are sort of reevaluating the situation. Can you just talk about some market share gain opportunities against Huawei?

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Northern Europe, we have been asked by one of the Tier 1 customer to replace Huawei, and we are in the final stage of signing a contract. And so certainly that Huawei difficulties has gaining us a Tier 1 opportunity in Northern Europe. And also, in Japan, next year, we expect that Japan could be, if not, top country for our revenue, but also it certainly will be top 3 as far as the country is concerned, but we expect \$50 million plus revenue from Japan.

**Ku Kang** - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Next year?

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Yes.



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**Ku Kang** - *B. Riley FBR, Inc., Research Division - Senior Analyst of Optical Components*

Got it.

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**Operator**

Our next question comes from the line of Tim Savageaux with Northland Capital.

**Timothy Paul Savageaux** - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Congrats on all the contract wins. And on the last comment, around contribution from Japan, kind of seeds into my question, and also kind of based on your previous comment, Yung, about accelerating organic growth in fiscal '20 as a result of these 5G deployments, and what I would like to get is kind of an updated sense of what you expect your organic growth to be in calendar '19 sort of implicit in your guide. I would assume that, that has upticked a bit, given the cuts that you've made are principally coming out of KEYMILE. And I would also, just quick math, say that's around 10% or 11%, but I would like you to confirm that and also perhaps comment on the magnitude of acceleration you expect in calendar '20?

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

I didn't get -- I mean, obviously, that we reduced our full year revenue guidance by about \$5 million. And I think it's a reflection of the Indian business first of all shifting to Q4 from Q3 and also the European Tier 1 carrier spend being cut. So I think that's in my consideration is about \$5 million -- between \$5 million and \$10 million if you want to go to the negative side more. And also that we tightened our margins to be a tighter range than previous, but if you look at our Q2, our margins were 33.2%. So I think -- I take that there are -- I like to adjust our earnings to reflect the reality. That does not mean that our business is not having momentum.

**Timothy Paul Savageaux** - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

That's what I -- the question was more focused on comparable organic growth rates into '20. Let me try it another way. What do you expect the Japanese contribution to your business to be this year? Does the \$50 million is comparable to what that you mentioned for next year?

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

I think we will see that the Japanese contribution around \$30 million to \$35 million above.

**Timothy Paul Savageaux** - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Great. I think, I can take it from there.

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Next year, we expect more than \$50 million, but it could outperform that \$50 million plus. I would say \$50 million plus. Japanese business will grow 50% and there about next year.

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**Operator**

And our next question comes from the line of Jon Gruber with Gruber & McBaine.

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**Jon Deroy Gruber** - *Gruber & McBaine Capital Management, LLC - Co-Founder, Principal, and Manager*

Quick question. One, congratulations on the Softbank win and the Rakuten intent. They are an aggressive company, Rakuten. How long before you get your orders signed and sealed and ready for delivery? How long a time period you think that will take?

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

I think we have to sign the order by December because we have to deliver the actual working model by end of this year. And by February, they will start putting a sizeable order. So that's Rakuten, and you know who we were against, okay? And we also came across the same company in Softbank. We won another contract in Softbank, which is a more sell-side switch, which is (inaudible) against the same company. Yes, So it shows that we are very competitive compared with one of the top technical company operating globally. So we have beaten them. I think we can chase their customers.

**Mikhail Golomb** - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

This is Mikhail, I just want to say one comment. I'm not going to go into details, but you would expect from those contracts much higher margins, gross margins than their typical margin profile.

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Usually, you know Japanese, their initial contracts is like mid-tens of millions. And from our earlier experience with Softbank, the total revenue was 3x initial contract. They rather tend to be conservative than being bullish in the contract.

### Operator

Ladies and gentlemen, that wraps up our question-and-answer session. And we would like to thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a wonderful day.

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