DASAN Zhone Solutions' (DZSI) CEO Yung Kim on Q1 2018 Results - Earnings Call Transcript
May 10, 2018 11:18 PM ET

|
DASAN Zhone Solutions, Inc. (NASDAQ:DZSI) Q1 2018 Earnings Conference Call May 10, 2018 5:00 PM ET

Executives
Pei Hung – Vice President-Investor Relations
Yung Kim – Chief Executive Officer
Michael Golomb – Chief Financial Officer

Analysts
Tyler Burmeister – Craig-Hallum

Operator
Good day and welcome to the First Quarter 2018 DASAN Zhone Solutions Inc. Conference Call. I'm Chelsea and I'll be your coordinator for today. At this time, all participants are in a listen-only mode. We will be facilitating a question-and-answer session towards the end of the conference. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes.
I would now like to turn the call over to your host for today, Ms. Pei Hung, Vice President of Investor Relations. Please proceed.

Pei Hung
Thank you, operator and good afternoon. Welcome to the first quarter 2018 DASAN Zhone Solutions Inc., earnings conference call. Joining me on the call today are the Chief Executive Officer of DASAN Zhone Solutions, Yung Kim as well as Chief Financial Officer, Michael Golomb.

As a reminder this conference call will be available for audio replay following this call. The dial-in instructions for the replay are available on our press release issued today as well as the Investor Relations section of our website www.dasanzhone.com.

Before we begin, I'd like to mention that in this call, we will refer to forward-looking statements regarding our future financial and operating performance and our growth strategy. Listeners are cautioned that actual results could differ materially from those expressed in or contemplated by the forward-looking statements.

Factors that could cause actual results to differ are detailed in today's earnings press release, in our annual and quarterly report filed with the SEC. The Company undertakes no obligation to update or reverse any forward-looking statements. During the course of this call, we will discuss both GAAP and non-GAAP financial measures specifically our reference to adjusted EBITDA. Reconciliation of GAAP to non-GAAP measures is included in our earnings press release and will also be posted on our website.

With those comments in mind, I'd now like to introduce Yung Kim, CEO of DASAN Zhone Solutions. Yung?

Yung Kim
Thank you, Pei, and good afternoon everyone. I like to begin by discussing our first quarter results. We performed well compared to our expectations during the March quarter. Reflecting the implementation of the new revenue accounting standard, ASC 606, our total revenue in the quarter was $59.5 million, which came in line with our guidance and reflected approximately 14.2% year-over-year growth.
We saw strong demand from our broad base of customers, with a particular geographic strength in the U.S. and in Latin America. I would attribute our double-digit revenue growth to a strong cross-selling of our broad set of products into a diversified base of loyal customers.

We benefit from both geographic and market segment diversification. We primarily sell into the leading Tier-1 carriers in the Asia-Pacific region and they primarily sell into Tier 2, 3 and alternative carriers in the Americas, Europe and the Middle East and Africa, in addition to several Tier-1 carriers in the Middle East.

I also see revenue growth from new customers in reviewing our base of top-10 customers for the quarter compared to the March 2017 quarter. I'm excited to see that three of our top-10 customers are new additions to this list. Additionally, growth with these customers has continued to diversify our geographic footprint as some of them have brought us into new markets. We are finding that, especially in emerging markets, broadband access technology is leap-frogging directly to fiber, especially if there was no existing telephone or legacy copper infrastructure.

Given that we have a very global footprint from a sales, production, R&D and employee based perspective, I'm confident we are best positioned to capitalize on these global trends. From a macro perspective, we see the acceleration of a fiber-based GPON as one of the fastest-growing broadband access technologies across global markets.

One of the drivers for adoption is the growing slate of 4K ultrahigh-definition content and increasingly AK UHD content. This is driven in part by consumer demand as the cost of ultrahigh-definition displays have come down and are becoming increasingly affordable for more consumers.

As you can imagine, the bandwidth requirements for AK videos are significant and can require up to 80 to 100 megabits per second. This compares with current 4K UHD technology, where bit-per-second requirements may be less than 20 megabits per second. I believe those service providers that cannot deliver the speed at which consumers are consuming content will be sidelined and disrupted. We are already benefiting from this emerging trend, where more innovative, alternative service providers, which we count as our customers, are taking share from the legacy service providers.

I would even say that the same disruption is headed to the enterprise markets. The confluence of events, such as the CAT 6, 7 upgrade cycle and the increasing demand for delivering gigabit to the desktop, is driving positive discussions with our customers. They are finding that the limitation of copper is quickly becoming a reality.

Now turning back to our financial results. On the margin front, our gross margin was 36% for the March quarter, which solidly exceeded the high end of guidance of 32%, even with the impact of ASC 606 implementation. Michael will share details on this gross margin outperformance later on the call.

You might recall, on our last earnings call, I spoke about 2017 being a watershed moment for us, as we turned profitable from an operating income adjusted EBITDA and net income perspective. We continue to be focused on scaling profitably. In Q1, we continued to deliver profitability across our operating income, adjusted EBITDA and net income. While our results met or exceeded our guidance from revenue, gross margin and EBITDA perspective, we continue to strive for more.

I believe we have the right set of solutions and strategy to win across this increasingly fragmented and the very global service provider market. With this overview, let me turn the call to Michael, who will discuss our quarterly financial result in more detail. Michael?

Michael Golomb
Thank you, Yung, and good afternoon. I will speak about our first quarter 2018 results and discuss what we are seeing for the second quarter 2018. We last provided you with a guidance regarding the Q1 2018 quarter on the February 28. The guidance we provided was before recognition of any potential impact from the adoption of the new revenue accounting standard, ASC 606.
In our guidance, we called for Q1 2018 revenue to be between $59 million and $60 million. A GAAP gross margin between 31% and 32%; adjusted operating expenses, which exclude depreciation, amortization, stock-based compensation expenses, to be approximately $0.5 million lower than Q4 2017 adjusted operating expenses. And lastly, a range of between breakeven to approximately $600,000 in adjusted EBITDA.

We adopted the new revenue accounting standard, ASC 606 on January 1, 2018, using the modified retrospective approach. As such, I'll be discussing our first quarter ended March 31, 2018, results, which reflect the financial impact of this adoption standard. Relative to the guidance, our actual revenue for the first quarter came in line, with the guidance at $59.5 million, which is up 14.2% year-over-year compared to $52.1 million reported in Q1 2017.

The change in the new revenue accounting standard, ASC 606 slightly reduced this quarter's revenue from approximately $60 million, which would have been reflected an increase of 15% year-over-year. The accounting impact of the adoption also led to transitional adjustment of approximately $310,000 into Q4, 2017 retained earnings, as small revenue would have been recognized in Q4 2017 under the new revenue accounting standard guidance.

Now I'd like to spend sometime discussing our revenue mix. Overall, revenue strength was broad-based, with growth coming from most geographies, including North America, which was up approximately 30% year-over-year. Some of our key wins in 2017 were in North America, which has been a very reliable market for us. It has contributed to our growth in this quarter as well.

International growth was up approximately 9% year-over-year, driven by Latin America and EMEA as well. Our company is very global in nature, as you know. In March quarter, we generated approximately 71% of our revenue outside of North America. Across international markets, Asia Pacific contributed approximately 45% of Q1 2018 revenue. We are seeing strong customer traction in EMEA and Latin America, which, collectively, accounted for approximately 26% of our Q1 2018.

From a customer perspective, we continue to diversify our customer base such as that no one customer represented more than 10% of our Q1 2018 revenue. As Yung mentioned earlier on the call, in reviewing our base of top-10 customers for the quarter compared to the March 2017 quarter we see even more customer and geographic diversification.

Our changing customer mix speaks to our belief that the service provider industry landscape is shifting. The industry is becoming more fragmented and even more global in nature than ever. We are benefiting from this shift as our customer base, including Tier-2 and Tier-3 customers and alternative providers in North America and Europe as well as Tier-1 providers in Middle East and Africa, continue to innovate and invest in bringing fiber to home.

Now turning to the gross margins. Gross margins of 36.5% significantly exceeded the high end of our gross margin's guidance of 32%. We attribute the gross margin outperformance to geographic mix and in particular, our strong U.S. performance in the quarter. We also benefit from manufacturing cost efficiencies and economies of scale.

As previously discussed, we are able to leverage flexible production out of our own in-house manufacturing facility in Florida and from our Asian-based contract manufacturers, so we can optimize from production costs. In this quarter, our total operating expenses on the GAAP basis were $21.5 million, an increase of $0.7 million compared to $20.8 million for the first quarter of 2017.

On a non-GAAP basis, our Q1 2018 adjusted operating expenses were $20.4 million compared to $19.3 million for the first quarter 2017. From a sequential perspective, our Q1 2018 adjusted operating expenses of $20.4 million were approximately $1.1 million higher than Q4 2017 adjusted operating expenses of $19.4 million. The increase was in part driven by approximately $600,000 from increased targeted R&D investments, including work related to our next-generation FiberLAN offering, which will be commercially available later this year.

The difference between GAAP versus non-GAAP operating expenses in Q1, 2018, was due to depreciation and amortization expenses and stock-based compensation expenses. On a non-GAAP basis, our adjusted EBITDA for the first quarter 2018 was $1.4 million, reflecting the margin of 2.4%. Our adjusted EBITDA exceeded our previously provided guidance range of between breakeven to $600,000, benefiting from strong revenue growth, outperformance in gross margins and operating leverage.

Know that we exceeded our adjusted EBITDA guidance even with the impact of adopting the new revenue accounting standard. Excluding the impact of ASC 606 adoption, our adjusted EBITDA for Q1 2018 would have been $1.6 million, which reflected a margin of 3.6%.
In the first quarter 2018, we continued to be profitable on the GAAP basis, posting net income attributed to DASAN Zhone Solutions of $0.1 million or $0.01 per fully diluted share compared to net loss of $3.7 million or loss of $0.23 per fully diluted share in Q1 2017. Excluding the impact of ASC 606 adoption, our net income attributed to DASAN Zhone Solutions would have been approximately $0.2 million in Q1 2018.

Now I would like to turn our discussion to the revenue outlook for the second quarter 2018 and introduce full year 2018 revenue guidance. For the second quarter 2018, we expect revenue to be in the range of $72 million to $78 million or approximately 20% to 30% year-over-year increase from the second quarter 2017 of $59.9 million. This reflects the continued broad-based revenue strength across customers, products and geographies. So the one-time benefit from a significant opportunity from India with a single customer.

For the full year 2018, we expect our revenue to be in the range of approximately $265 million, $270 million or approximately 7% to 9% year-over-year growth, which reflects our business on a run-rate basis without the impact of a large one-off deal. While we believe there is a continued growth opportunity in markets like India, we did not consider it in our full year top line outlook.

Getting back to our second quarter 2018 guidance, we expect our GAAP gross margins to be in the range of 30% to 31%, which does reflect the impact of recent wins in our Asia-Pacific region. We expect second quarter 2018 non-GAAP operating expenses to be between $20.7 million and $21.5 million, which is slightly higher than Q1 2018 levels, given anticipated top line growth in Q2. We are expecting Q2 2018 adjusted EBITDA to be between $1 million and $2.5 million.

At this point, let me turn over back to Yung.

Yung Kim
Thank you, Michael. To wrap up, we continue to be excited about our growth prospects. We believe we will benefit from a confluence of a macro trend that we have discussed on today's call and strongly believe that the market opportunity is ours to seize.

Operator, we are now ready to open up for any questions that our listeners might have.

Question-and-Answer Session
Operator
Thank you. [Operator Instructions] Thank you. And our first question comes from Tyler Burmeister with Craig-Hallum.
Tyler Burmeister
Hi, guys. This is Tyler on behalf of Christian. Thanks for let me ask a couple of questions.
Yung Kim
Hello.
Tyler Burmeister
First, it's good to see the revenue guidance for the year, 7% to 9%. I was wondering if you had any visibility or you could provide any color on what the back half might look like as far as a quarter breakout? Are we looking relatively even quarters in the back half, growing in the back half? Any color there would be great.
Yung Kim
As we mentioned in our statements that we took a significant win from India. And taking that aside, our back end will still grow, so what I have – what I'm saying is, taking that one-off, we are not thinking – even though that we're working on follow-on opportunity, I'm not taking that into account into our projections. So that's – Indian win we just treated one-off. But in fact, we are working on follow-on, but it's not in the year-end or the 2018 total figure. So coming back to your original question, yes, it's growing. It's not static.
Tyler Burmeister

Okay, maybe…

Yung Kim

But that will not be a $70 million to $78 million in the next two quarters, no. We're talking about the baseline of $59.5 million will grow much more than that in the third and fourth quarter, significantly.

Tyler Burmeister

So maybe another way, my math is that in the back half, your guide implies kind of $66 million a quarter. Would that be split evenly September to December or those quarters would be flat? Would December be higher?

Yung Kim

Traditionally, the third quarter, including the vacation quarters, we don't expect much of activity. But that will be more in the Q4.

Tyler Burmeister

Okay, perfect. Perfect. And then on the gross margins, the guidance for Q2 was 30% or 31%. Is that a good run rate to think about your business going forward? Obviously, this quarter was a nice surprise. The upside is 30% to 31%, still the kind of run rate level we should be thinking about.

Yung Kim

Yes. Michael will answer that.

Michael Golomb

Yes. So thank you for your question. So for now – as we stated during the call, we expect to have 30%, 31% on average, specifically because of our wins in Asia – the Asia-Pacific region. For now that's our target for the year on average.

Tyler Burmeister

All right, great. And then OpEx, just around the south, is coming up again modestly in Q2. Should we continue to expect that to ramp for the rest of year? Should we expect that to come down, without the one-time kind of larger revenue in Q2? How should we think about OpEx for the rest of the year?

Yung Kim

We think that – we don't expect the same level of OpEx in Q3, Q4. We expect it will come down. It is to counter the one-off revenue in Q2. But if there are other big opportunities we succeed in getting, then the expense might go, but it will be reinforced by the higher revenue. And we've been conservative in our outlook at the margins.

Michael Golomb

Right. If we're going to – your question to continue on OpEx, if you compare it year-over-year as percent of revenue, we're actually doing quite well, right? If you look at Q1 2018 to Q1 2017, we are 36% versus almost 40% of revenue. And we – our goal is to keep our expenses in order. As you know, we are not expensing – we're not capitalizing any R&D expenses, some of our competitors do. And we try to be very laser-focused on how we look at our current expenses.

Tyler Burmeister

All right, great. Thank you. That’s all from me.

Operator

Thank you. And I'm showing no further questions at this time. Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a great day.

AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.