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DASAN Zhone Solutions, Inc. NasdaqCM:DZSI

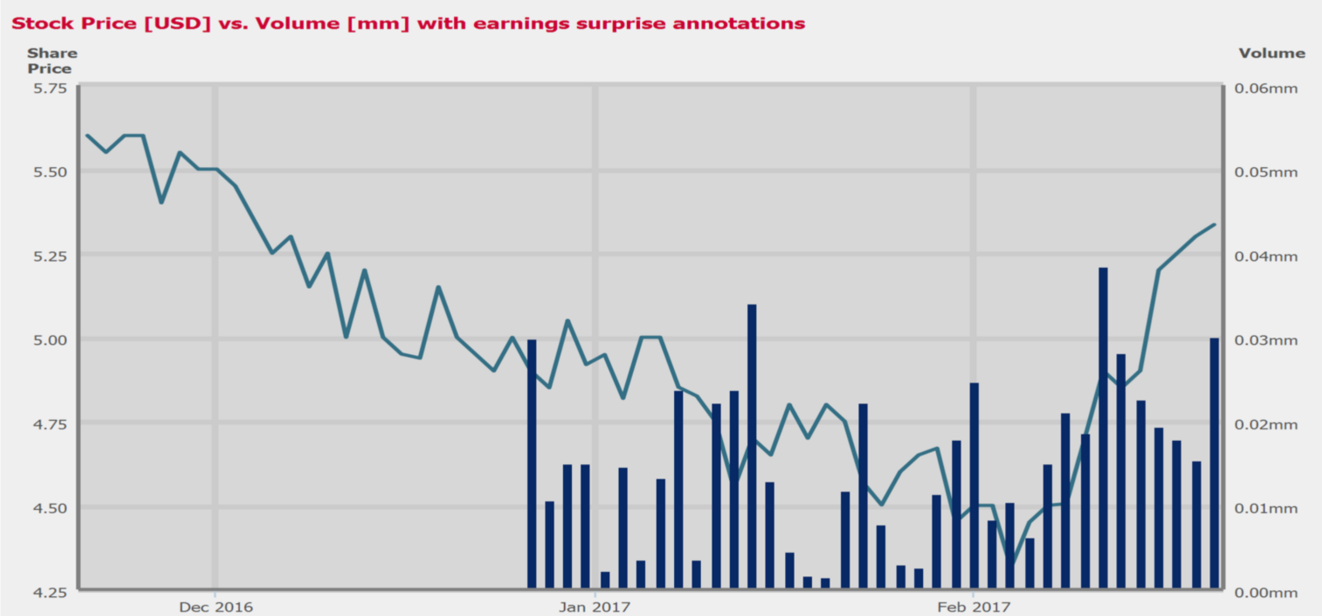
FQ1 2017 Earnings Call Transcripts

Tuesday, May 16, 2017 9:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2017-			-FQ2 2017-	-FY 2017-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	GUIDANCE
EPS Normalized	(0.25)	(0.22)	NM	(0.15)	(0.35)	-
Revenue (mm)	50.02	53.07	▲6.10	53.02	219.11	220.00

Currency: USD
Consensus as of Feb-22-2017 12:14 PM GMT



- EPS NORMALIZED -			
	CONSENSUS	ACTUAL	SURPRISE
FQ4 2016	(0.05)	(0.34)	NM

Call Participants

EXECUTIVES

James D. Norrod
Former Co-CEO & Director

Kirk Misaka
Former Treasurer & Secretary

Yung Kim Il
CEO, President & Director

ANALYSTS

Alan Davis

Presentation

Operator

Good day, and welcome to the First Quarter 2017 DASAN Zhone Solutions, Inc. Conference Call. I'm Karen, and I'll be your coordinator for today. [Operator Instructions] And as a reminder, this conference is being recorded for replay purposes.

I would now like to introduce Kirk Misaka, DASAN Zhone Solutions' Chief Financial Officer. Please proceed, sir.

Kirk Misaka
Former Treasurer & Secretary

Thank you, operator. Hello and welcome to the First Quarter 2017 DASAN Zhone Solutions, Inc. Earnings Conference Call. I'm here today with the Co-CEOs of DASAN Zhone Solutions, Yung Kim and Jim Norrod.

Yung is responsible for DZSI's product strategy and technology development and will begin with comments about DZSI's current product portfolio and future road map. Jim is responsible for DZSI's sales and marketing and will follow with comments about DZSI's markets and the delivery of DZSI's products through our combined sales channels.

Following Jim's comments, I will discuss DZSI's financial results for the first quarter and provide guidance for next quarter. In addition, I will provide more details about our 2017 operating model and financial objective. After our prepared remarks, we will conclude with questions and answers.

This conference is being recorded for replay purposes and will be available for approximately 1 week. The dial-in instructions for the replay are available on our press release issued today. An audio webcast replay will also be available online at www.dasanzhone.com following the call.

Before we begin, I'd like to mention that during the course of this call, we may make forward-looking statements that are subject to the safe harbors created under the Securities Act of 1933 and the Securities Exchange Act of 1934. Words such as anticipate, believe, continue, could, estimate, expect, goal, intend, may, plan, project, peak, should, target, will, would and variations of such words and similar expressions, are intended to identify forward-looking statements. In addition, forward-looking statements include, among others, statements that refer to financial estimates and projections of revenue, margins, expenses or other financial items.

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 include, but are not limited to, commercial acceptance of the company's products; intense competition in the communications equipment market; the company's ability to execute on its strategy and operating plans; and economic conditions specific to the communications, networking, Internet and related industries. In addition, please refer to the risk factors contained in the company's SEC filings available at www.sec.gov, including, without limitation, the company's annual report on Forms 10-K, 10-Q and 8-K.

Readers are cautioned not to place undue reliance on any forward-looking statement, which speak only as of the date on which they are made. The company undertakes no obligation to update or revise any forward-looking statements for any reason.

With those comments in mind, I would now like to introduce Yung Kim. Yung?

Yung Kim Il
CEO, President & Director

Thank you, Kirk, and greetings to those participating on today's call. On the product side, while continue concentrating on our core areas, we see service providers continuing to deploy both Fiber-to-the-Home with the PON and active Ethernet and hybrid copper fiber solutions to meet the demand for more bandwidth.

Many carriers have deployed the V series OLTs, MXK and MXK-F for pure FTTx applications. We see a move by carriers to increase the bandwidth for a subscriber on accessed networks, driving forward the ability to offer 1-gigabit service for residential and business services.

Carriers are moving to 10-gigabit PON or reducing the number of subscribers on an individual optical distribution network. Carriers are also deploying deep fiber as close to the customer as possible to leverage existing copper infrastructure. We see growth in deployment of our VDSL2 and G.fast technologies to meet this growing bandwidth need.

The need for greater bandwidth is also being felt by wireless service providers. Wireless service providers are upgrading bandwidth to each of their cell sites as well as starting to plan for wider area 4G implementation and for 5G migration. Today, our MEF-certified, MPLS-enabled M series products are already deployed as well as being evaluated for wireless service providers. Also, carrier radio access networks continue to grow in both bandwidth per radio access and number of nodes.

As the mobile landline access networks grow, the next level of Ethernet aggregation is being put under pressure. We see the aggregation Ethernet switches and the data center switches requiring upgrades to 10G and higher. These network upgrades constantly occur beyond the traditional Layer 2 and Layer 3 switching technologies. Carriers are looking to leverage existing deployed Ethernet switching nodes to migrate to SDN-based solutions. Our V series Ethernet solutions are the perfect solution to allow carriers to migrate without forklift upgrade.

Enterprise customers are deploying passive optical LAN at record pace as it is proven to be the most cost-efficient solution in the industry today. We have recently seen the demand rising to enhance customer experience at the sports and entertainment venues with the abundance of bandwidth available from passive optical LAN. Architects and integrators are now seriously looking to fiber LAN as the perfect solution for these types of deployment.

DZSI continues to develop the future of networking by leveraging our existing expertise in PON, DSL and Ethernet and marrying it with both open-source software and internally developed networking solutions.

We are working with our carrier customers to virtualize not just network assets but to provide complete virtualized network overlays. Service providers will leverage this work for residential and business services, 5G-based cloud radio access networks and inter-data center virtual machine interconnections.

With that said, I will turn the call over to Jim Norrod to talk about our markets and our customers' genuine interest in our products and solutions.

James D. Norrod
Former Co-CEO & Director

Thank you, Yung. As I mentioned on our last earnings call, we're very excited about the market opportunity created by the merger of DASAN Network Solutions and Zhone Technologies. This quarter was our second full quarter of combined operations, and we continue to see increasing benefits from the combination.

As a leading provider of broadband access, Ethernet switching, mobile backhaul and passive optical LAN products, our customers can now buy full end-to-end solutions to manage their networks. Demand for these solutions is high, and after the merger closed, we immediately began cross-selling to each company's loyal customer base with a unified sales and support team in every major geographic region.

As discussed last quarter, the cross-sell interest exceeded our expectations as demonstrated by the level of request for demo equipment by our customers that wanted to immediately begin lab testing product offerings that were not available to them before, and we received actual cross-sell orders that we did not expect until later in 2017.

As a result of that demonstrated strength, we raised our revenue guidance from $210 million for 2017 to $220 million. In the first quarter, we saw that momentum accelerate, accompanied by a significant increase in backlog and pipeline of opportunities. Based on these factors, we now believe revenue will grow even more in 2017 and should reach about $230 million for the year. Kirk will give you the details in a minute.

As we have discussed before, DASAN was a leading telecom equipment provider in the Asia Pacific region to some of the largest carriers in the region, including the 3 largest carriers in Korea and other Tier 1 carriers in Japan and Vietnam. Zhone, on the other hand, was a leading player with alternative carriers in the Americas, Europe and EMEA, in addition to several Tier 1 carriers in the Middle East.

What was encouraging about the first quarter results was that revenue strength came from all geographic regions and that our global sales force began collaborating together on many of those opportunities. We think that bilateral cooperation between the previously separate sales teams will be important to achieve best-of-class performance. So far, we're very encouraged by the teamwork, and obviously, it is leading to great results.

As excited as we are about the breadth and strength of our customer base, we are equally excited about the breadth and strength of our product portfolio. For the rest of 2017, we expect that revenue growth will be driven by 2 major product catalysts: First, we will continue to cross-sell DASAN's Ethernet switching and mobile backhaul products to Legacy Zhone customers. Secondly, we will grow revenue in the passive optical LAN business through our enhanced global sales force and marketing focus.

Meanwhile, we expect our broadband access products to continue to be the core of our product portfolio that will enable the growth in our other product segments.

On the marketing front, we've given DASAN Zhone Solutions a fresh new brand and will soon launch an integrated website focused on our best-in-class products, solutions and people. We will invest more in marketing this year to get our message out about the value proposition associated with each of our product focused areas, and we expect that effort to further increase interest in our products.

As for the business integration process, we've taken the best people, the best processes and the best products of both companies. And with those strengths, I am convinced that we will grow revenue even if we encounter difficult market conditions.

Although complex with many moving parts, the integration is going smoothly and basically complete. We now face the market as a stronger, more efficient combined company. And although most of the cost-cutting effort is behind us, cost efficiency will always be a priority. Revenue growth and cost efficiency will be the major contributors to reaching profitability in 2017.

Longer term, we're also focused on improving gross margins and expect to see the benefits of our integration efforts to reduce the cost of our products and to put to use the excess manufacturing capacity in our Florida facility.

With that brief overview, let me turn the call back to Kirk, who will provide more details about our financial results for the first quarter and our financial guidance for the future.

Kirk Misaka
Former Treasurer & Secretary

Thanks, Jim. Revenue for the first quarter of 2017 was $53.1 million and came in higher than our upwardly revised guidance of approximately $50 million. Revenue strength came from all geographic regions. North America revenue was particularly strong in the first quarter and increased to about 25% of total revenue as compared to approximately 19% in the fourth quarter of 2016. As expected, the majority of our revenue is still generated in Asia, representing about 55% of total revenue over the past 2 quarters.

As Jim mentioned, several indicators suggest that revenue growth in 2017 will be stronger than previously expected, including the lab test activity and cross-sell orders of new product offering coming from Legacy Zhone customers as well as the growing backlog and pipeline of opportunities for existing product offerings.

Based on these indicators and after 2 full quarters of combined operations behind us, we feel more confident about top line growth and now expect annual revenue to grow to about $230 million, which represents more than 10% growth over the 2016 pro forma combined revenue of the merged companies. We expect quarterly revenue to increase sequentially for the rest of the year and expect second quarter revenue to be approximately $56 million.

Gross margins for the first quarter of 2017 were 34.3%, and much higher than our 30% financial guidance and pro forma historical norms. Better gross margins were largely driven by favorable geographic mix, with a higher concentration of revenue from North America and Japan, where gross margins are higher than company average. We are also starting to see some gross margin expansion from the manufacturing cost side as well.

As we discussed last quarter, we expected longer-term gross margin expansion coming from product cost reductions and manufacturing economies of scale in the latter half of 2017. It's encouraging to see that some of those benefits are already being captured. Although we expect that our geographic mix will normalize over the coming quarters, the manufacturing cost benefits should remain. Therefore, we are increasing our estimate of gross margins for the remainder of the year from 30% to about 32%.

Operating expenses for the first quarter of 2017 totaled $20.4 million and included depreciation and amortization of approximately $1 million and stock-based compensation of approximately $300,000. Adjusted operating expenses, excluding depreciation, amortization and stock-based compensation, was approximately $19.1 million and higher than our forecast, largely due to additional legal and accounting costs.

For the second quarter of 2017, we expect adjusted operating expenses to begin declining as we expect increasing benefits from merger cost synergies over the remaining 3 quarters of 2017. For the second quarter of 2017, we expect adjusted operating expenses to drop by about $1 million and then another $500,000 by the fourth quarter. Depreciation and amortization could be about $1.2 million in the second quarter and decline to about $800,000 in the fourth quarter. Stock-based compensation could be about $300,000 per quarter and remain at that level for the remaining quarters of 2017.

Our non-GAAP adjusted EBITDA loss for the first quarter was $1.3 million; and our GAAP net loss, $3.6 million, both of which were better than expected due to higher revenue and gross margins, offset somewhat by higher operating expenses. Based on our revised financial guidance, we expect that we will be generating positive adjusted EBITDA by the third quarter of 2017 and positive GAAP net income by the fourth quarter.

As Jim stated, profitability is our immediate and primary financial goal, and it will be driven by revenue growth from cross-selling opportunities and new growing markets in mobile backhaul and passive optical LAN, improved gross margins from manufacturing cost reductions and economies of scale, and operating expense reductions from cost synergies associated with the merger.

Now let's take a quick look at the balance sheet. Cash and cash equivalents at March 31, 2017, were $17.3 million, similar to the $17.9 million at December 31, 2016. Meanwhile, we funded the growth in accounts receivable and inventory through short-term debt from Korean sources.

Going forward, we expect our debt structure with Wells Fargo will play a larger role in funding increases in working capital assets as our business grows.

Lastly, intangible assets and goodwill arose from the purchase accounting associated with the acquisition of Zhone that we talked about last quarter.

Before proceeding with questions, let me provide a brief update on our NASDAQ listing. As reported on our Form 8-K originally filed with the SEC on April 6, 2017, and subsequently updated on April 11 and April 25, DASAN Zhone Solutions was unable to timely file its annual report on Form 10-K for the year ended December 31, 2016, due to the identification of material errors in the consolidated financial statements of Legacy Zhone in periods prior to the merger and an ongoing independent investigation into those errors. As stated in the Form 8-K, the errors in Legacy Zhone's financial statement in prior periods do not impact the financial statements of DASAN Zhone Solutions following the merger, given the treatment of DASAN Network Solutions as the accounting acquirer in the transaction.

On April 6, 2017, we received notice from the listing qualifications staff of the NASDAQ indicating that, based upon our failure to timely file the 2016 Form 10-K with the SEC, we no longer satisfy NASDAQ's filing requirement as set forth in NASDAQ listing Rule 5250(c)(1). We requested a hearing before the NASDAQ hearings panel, which was granted and is scheduled for May 25, 2017. We also requested a further stay of any suspension in the trading of the company's common stock and in the outcome of the hearing and the expiration of any extension granted by the panel. At the hearing, we will present our plan to regain compliance with NASDAQ's filing requirement. In the meantime, we are diligently working to complete the investigation, complete the audit and filing of our 2016 Form 10-K and regain compliance with NASDAQ's filing requirement as soon as possible.

With that overview, we would now like to open up the call to questions. Operator, please begin the Q&A portion of the call.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Alan Davis from L. A. Davis & Associates.

Alan Davis

Just a couple of quick questions. First of all is, is FiberLAN having a meaningful effect on margins as of yet? And then as you now have 2 quarters under your belt, do you have a sense for kind of reasonable longer-term revenue growth guidance -- not necessarily guidance, just expectations, in terms of -- as you look to next year or the next 2 or 3 years, what kind of growth this company can achieve?

James D. Norrod
Former Co-CEO & Director

Alan, this is Jim. Thank you for the comments. Yes, fiber -- the FiberLAN margins, one reason we really like that business is the margins are typically higher than our average stated margins for the entire business. So it has a positive impact on the overall margins of the company. So that's one of the reasons that we like that business. And two, on the growth side, again we're not publishing numbers on it, but we're continuing to see -- as I've said, our goal is to double this business every year since I got here, and we're still seeing that. We still think that we have a real good opportunity to double that business year-over-year. It is spreading internationally very well, which is what I liked. We have just introduced it into the Asian customers from the DASAN Networks side, so we've introduced it to their customers. So we're still seeing a doubling effect of that business on a year-over-year basis, so I'm still very bullish that we'll continue that trend. And yes -- so I mean, positive on the margins. The other thing I'll tell you is that, what I like about it is they introduce new customers to us on the enterprise side. We -- again, I won't go through the detailed names here, but the names are household names that you would know, household hotel names that you would know, household sport stadiums that you would know. So it's all kind of named companies on the enterprise, and that's all new business to us, which I like. So yes, it's all continuing to be positive in my opinion. So thank you for your questions.

Alan Davis

Okay. And, Kirk, I had one follow-up. I may have missed this. Can you give any kind of timing or expectation for when you may have a 10-K finished?

Kirk Misaka
Former Treasurer & Secretary

No. Due to the ongoing nature of the investigation, we'll not be making any further comments until the investigation is complete, which is obviously a prerequisite for filing the 10-K.

Operator

[Operator Instructions] And that concludes our question-and-answer session for today. I would like to turn the conference back over to DASAN Zhone Solutions for any closing comments.

Kirk Misaka
Former Treasurer & Secretary

All right, Karen. Thank you. Again, thanks for all of you joining us today, for your continued support. The merger has created significant value for our customers and our investors, of course, and our financial results are just beginning to reflect that value as we expect that momentum will continue to accelerate through the remainder of the year. Our financial goals remain returning to profitability and generating shareholder value. So we look forward, of course, to talking to you on next quarter's earnings conference call, when we will discuss our progress towards achieving those objectives.

So again, thank you so much for your support, and we'll talk to you all soon.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program, and you may now disconnect. Everyone, have a great day.