CONTENTS

DASAN Zhone Solutions, Inc. NasdaqCM:DZSI

FQ2 2017 Earnings Call Transcripts

Wednesday, August 09, 2017 9:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2017-			-FQ3 2017-	-FY 2017-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	GUIDANCE
Revenue (mm)	55.89	60.11	▲7.55	58.85	229.78	220.00

Currency: USD
Consensus as of May-18-2017 12:25 PM GMT

Call Participants

EXECUTIVES

James D. Norrod
Former Co-CEO & Director

Kirk Misaka
Former Chief Financial Officer

Yung Kim Il
CEO, President, Acting CFO & Director

ANALYSTS

Alan Davis

Tyler Leroy Burmeister
Craig-Hallum Capital Group LLC, Research Division

Presentation

Operator

Good day, and welcome to the Second Quarter 2017 DASAN Zhone Solutions Incorporated Conference Call. I'm Karen, and I'll be your coordinator for today. [Operator Instructions] 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.

Kirk Misaka
Former Chief Financial Officer

Thank you, operator. Hello, and welcome to the Second Quarter 2017 DASAN Zhone Solutions, Inc. Earnings Conference Call. I'm here today with co-CEOs of DASAN Zhone Solutions, Yung Kim and Jim Norrod. Yung will begin in with comments about DZSI's current product portfolio and future road map. Jim 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 second quarter and provide guidance for next quarter. In addition, I will provide more details about our operating model and financial objectives for the remainder of the year. 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. And audio webcast replay will also be available online at www.dazanzone.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. In addition, forward-looking statements include, among others, statements that refer to financial estimates and projections of revenue, margins, expenses or other financial items. Readers 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 could 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 filings on Forms 10-K, 10-Q and 8-K. Listeners are cautioned not to place undue reliance on any forward-looking statements, 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, Acting CFO & Director

Thank you, Kirk, and greetings to those participating on today's call. On the product side, we continued to focus our efforts on delivering best-in-class products in 5 key product areas: broadband access, Ethernet switching, mobile backhaul, passive optical LAN and software-defined networks. Let me spend a few minutes discussing each of these areas in more detail.

We developed our broadband product for all aspects of carrier and service provider access networks. We developed customer premises equipment such as DSL modems, Ethernet access demarcation devices, gigabit passive optical network, or GPON, and the gigabit Ethernet passive optical network, or GEPON, optical network terminal.

We also developed central office product such as broadband loop carriers for DSL and voice-grade telephone services, high-speed digital subscriber line access multiplexers or called DSLAMs with a very high bit-rate G.fast and the VDSL capabilities, optical line terminals for passive optical distribution networks like GPON and GEPON as well as point-to-point Ethernet service for 1-gigabit to 10-gigabit access.

Our Ethernet switching product provides a high performance and manageable solution that bridges the gap from carrier access technologies to the core network. Ethernet switching product support pure Ethernet switching as well as layer 3 IP and MPLS capabilities and are currently being developed for interfacing with SDN. Legacy Zhone did not offer a comparable Ethernet switching product prior to the merger, and we are already seeing some legacy Zhone customer traction in the market that Jim will discuss further.

Our mobile backhaul product provides a robust manageable and scalable solution for mobile operators that enable them to upgrade their mobile backhaul systems and migrate to LTE and beyond. Our mobile backhaul product may be collocated at the radio access node base station and can aggregate multiple base stations into a single backhaul for the delivery of a mobile traffic to the RAN network controller. We will provide standard Ethernet IP or multiprotocol label switching, MPLS interfaces and interoperate with other vendors in these networks. Mobile backhaul has become one of the most important parts of the network due to the explosive growth of mobile data traffic. We expect this area to also provide strong revenue growth in the coming years.

Our FiberLAN portfolio of POLAN products are designed for enterprise, campus, hospitality and entertainment arena uses. Our environmentally friendly FiberLAN solutions are one of the most cost-effective LAN technologies that can be deployed, allowing network managers to deploy a future proof, low maintenance, manageable solution that requires less space, air conditioning, copper and electricity than other alternatives.

Our DSN (sic) [SDN] and the network function virtualization or called NFV tools and the building blocks allow service providers to migrate their networks' full complement of legacy control plane and data plane devices to a centralized, intelligent controller. This move to SDN and NFV provides a better service for end customers and more efficient and cost-effective use of hardware resources for service providers. We leverage our broadband access, mobile backhaul and Ethernet switching expertise to extract virtualize many of the traditional legacy controlled data plane functions to allow them to be run from the cloud. The latest evolution of our hardware-based solution was designed to support SDN and NFV.

As we have said before, the combination of DNS and Zhone resulted in a robust and complementary product portfolio and will help service providers and enterprises managing their networks more efficiently and effectively, while allowing them to migrate to the latest technology to satisfy the exploding demand for bandwidth. The successful merger and integration of our 2 great companies has been accomplished. We are now fully prepared to compete successfully as a unified and stronger company going forward.

Revenue growth and cost efficiency will be the major contributors to reaching profitability in 2017. Longer term, we are also focused on improving gross margins and expect to see the benefits of our integration efforts to reduce the cost of our product and to put -- to use the excess manufacturing capacity in our Florida facility.

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

Thanks, Yung. As I've mentioned before, we are very excited about the market opportunity created by the merger of DASAN Network Solutions and Zhone Technologies. A year ago, we believed that the merger could create significant potential value. Today, we are pleased to see that potential converted into reality through the adoption of best practices, successful integration of our complementary products and the cross-selling of those products to our customers. With the successful integration of our businesses, we are seeing improved financial performance led by stronger-than-expected revenue growth. As you know, we began cross-selling to each company's loyal customer base with a unified sales and support team in every major geographic region immediately after the merger. The cross-sell interest exceeded our expectations, driving positive financial results, much sooner than we expected. As a result of that demonstrated strength, we raised our revenue guidance after our first quarter results from $210 million for 2017 to $220 million. In the second quarter, we saw that momentum accelerate, accompanied by a significant increase in backlog and pipeline of opportunities, and again, increased our annual revenue guidance to $230 million.

With the third straight quarter of better-than-expected revenue growth, we are once again raising our annual revenue guidance to $240 million for this year. Kirk will give you those details in just a minute. As we 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.

Revenue strength for the quarter came from all geographic regions driven by a global sales force collaborating together. As excited as we are about the breadth and the 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 continue to 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. Second, we will grow revenue in the passive optical LAN business through our enhanced global sales force. 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 segments -- product segments.

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

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

Kirk Misaka
Former Chief Financial Officer

Thanks, Jim. Revenue for the second quarter of 2017 was $60.1 million and came in higher than our upwardly revised guidance for of $56 million. As Jim mentioned, revenue strength came from all geographic regions. As we also mentioned, the growing backlog and pipeline of opportunities indicate that revenue will continue to be strong for the remainder of the year.

After 3 full quarters of combined operations behind us, we feel more confident about top line growth and now expect annual revenue to grow to about $240 million, which represents more than 15% 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 third quarter revenue to be approximately $62 million. Gross margins for the second quarter of 2017 were 32.2% and much higher than our roughly 30% pro forma historical norms.

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 and are -- we are optimistic that gross margins for the remainder of the year will remain around 32%.

Operating expenses for the second quarter of 2017 totaled $20.2 million and included depreciation and amortization of approximately $1.2 million, and stock-based compensation of approximately $200,000.

Adjusted operating expenses, excluding depreciation, amortization and stock-based compensation, was approximately $18.8 million and higher than our forecast largely due to additional legal and accounting costs.

For the third and fourth quarter of 2017, we expect adjusted operating expenses to be lower by about $500,000 per quarter. Depreciation and amortization should be about $700,000 for the third and fourth quarters, while stock-based compensation should continue to be about $300,000 per quarter for the remaining quarters of 2017.

Our non-GAAP adjusted EBITDA profit for the second quarter was $788,000, and our GAAP net loss was $938,000, both of which were better than expected due to higher revenue and gross margins offset somewhat by harder operating expenses.

Based on our revised financial guidance, we expect that our positive adjusted EBITDA will continue to improve for the remainder of the year and that we will generate positive GAAP net income by the fourth quarter.

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

Before proceeding with questions, let me provide a brief update on our NASDAQ listing. On June 7, 2017, we received a letter from the NASDAQ stating that the NASDAQ hearings panel had granted the company's request for continued listing on the NASDAQ Capital Market provided that on or before September 27, 2017, DASAN Zhone Solutions shall have filed with the SEC its annual report on Form 10-K for the year ended December 31, 2016, and quarterly report on Form 10-Q for the period ended March 31, 2017.

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 years ended December 31, 2016, due to the identification of material errors in the consolidated financial statements of Legacy Zhone and 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 statements 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. That investigation is now complete, and DASAN Zhone Solutions has implemented a number of remedial actions through among other things to prevent occurrences of such errors in the future. Our independent auditor has also resumed work on completing their audit of the financial statements of DASAN Zhone Solutions for the year ended December 31, 2016, and their review of the financial statements for the quarter ended March 31, 2017. We currently believe that we will be able to file the 2016 Form 10-K and 2017 Form 10-Q prior to the expiration of the NASDAQ's September 27, 2017, extension to regain compliance with their listing requirements.
With that overview, we'd 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] And our first question comes from the line of Alan Davis with L.A. Davis

Alan Davis

Just a couple of quick questions. Could you give us update on FiberLAN, kind of -- is that still on track as you stated maybe in prior quarters? Or when do you expect that, I guess, to become a significant business -- I guess, significant enough to start affecting your gross margins, which are already improving through other means? But just curious on an update on FiberLAN.

James D. Norrod
Former Co-CEO & Director

Thanks for the question. This is Jim. Yes, we continue to see growth, and I will tell you that the exciting thing for me in looking at how we are doing with FiberLAN, there are 2 things that are significant. One is the size of the deals are growing. They are much larger than -- when I came to the company, we are doing several smaller deals. Now without naming names, there are significant transactions becoming very large, very important, very critical to significant companies and supports avenues, supports situations. And so they're getting very, very big, which is good. The margins continue to hold up being higher than the access margins. And then, I guess, the third thing that I like is that we are seeing some growth in the international area, where I didn't think we would see the kind of growth we're seeing now. So major hotel chains in the Middle East, as an example, are starting to implement, so we are seeing really good growth internationally. So we're still not ready to break it out as a separate product category for disclosure purposes. We're not at that point. I think we said at one time, it'll be 10% of our total revenue. So we're still not there, but I will tell you that I'm pleased with the growth, I'm pleased with the gross margins, and I'm pleased with where the deals are happening now. So all in all, I'm very positive as to the impact on our business.

Alan Davis

Okay, great. And then one last one, Kirk. Just I know the cash was down, is that a payable timing thing or was there some sales associated with the restructuring business?

Kirk Misaka
Former Chief Financial Officer

Most of it relates to the growth in our balance sheet. You'll note that accounts receivable and inventory with the growing business use working capital and we're funding that off of our existing debt agreement.

Operator

And our next question comes from the line of Tyler Burmeister with Craig-Hallum.

Tyler Leroy Burmeister
Craig-Hallum Capital Group LLC, Research Division

This is Tyler on, on behalf of Christian, thanks for letting me ask a couple of questions. First, could you share with us a couple of customer examples of where you guys are seeing stronger-than-expected revenue growth?

James D. Norrod
Former Co-CEO & Director

Well, I guess, we don't really disclose customer names in these meetings. So I will tell you that -- maybe Yung you want to speak to [indiscernible]. But we -- in the past, I don't think we really disclosed names, because, first of all, we have competitors on this call, and I'm not interested in giving them information about my competitive wins, just doesn't feel right for me to...

Yung Kim Il
CEO, President, Acting CFO & Director

This is Yung. And one example is we have significant big carrier from Japan becoming our customer this year. And recently, we acquired a regional one as well with Korea, strong orders coming in next 2, 3 years. So I think, we are sort of progressing nicely, and I'm sorry that we can't disclose names, but it is a significant wins as well. And our orders in North America is also progressing well.

Tyler Leroy Burmeister
Craig-Hallum Capital Group LLC, Research Division

Okay. I understand you guys can't...

James D. Norrod
Former Co-CEO & Director

But we said in our earlier comments, we have the 3 largest carriers in Korea and Tier 1 carriers in Japan and Vietnam. We just said that earlier.

Yung Kim Il
CEO, President, Acting CFO & Director

Tier 1 carriers now.

James D. Norrod
Former Co-CEO & Director

Yes. So now at this juncture, we have 2 Tier 1 carriers there. So that's great news for us because we've kind of been thought of as a -- the Tier 2, Tier 3 company, but with DASAN coming on to the team with us, putting these 2 companies together, we picked up some really great Tier 1s throughout Asia, so that's great.

Tyler Leroy Burmeister
Craig-Hallum Capital Group LLC, Research Division

Okay. And then switching to gross margins. I believe you guys said you see 32% gross margins for the rest of the year. Can you help us how we think about gross margins kind of going forward? Could there be upside to that? And then the 35% kind of level that you reportedly lately, could there ultimately even be upside to that? How we think about gross margins?

Kirk Misaka
Former Chief Financial Officer

Tyler, this is Kirk. As I said, historical pro forma gross margins were closer to 30%. And we've raised our guidance last quarter to 32%. And it was because the integration of our production capabilities in Korea as well as in the United States allowed us to take advantage of some of the better pricing between the 2 sources as well as balance production more efficiently and take advantage of some of that production capacity that existed in our Florida facility. So all of those things are leading to greater efficiencies. And then we are also have started the effort of reducing the cost of our products by looking at less expensive material and -- in addition to the better sourcing that I just mentioned. And so we're already ahead, probably a quarter to 2 quarters ahead of where we have expected to be last quarter. And so we're stating that we think we can maintain that through the remainder of this year. Longer term gross margin expansion, we'll give some more details as we see -- as we get better visibility to what that might be able to go to.

Operator

And that concludes our question-and-answer session for today. I'd like to turn the floor back over to Yung Kim for any closing comments.

Yung Kim Il

CEO, President, Acting CFO & Director

Thanks, again, for joining us today and for your continued support. The successful merger and integration of 2 great companies has been accomplished. We are now fully prepared to compete successfully as a unified and stronger company going forward. The merger has also created significant value for our customers and investors. Our financial results are already reflecting the value, and we expect that the momentum will continue to accelerate through the remainder of the year. We look forward to speaking with you again on next quarter's earnings conference call when we will discuss our progress towards achieving that objective. Thank you.

James D. Norrod
Former Co-CEO & Director

Thank you.

Operator
Thank you. This concludes today's conference. Thank you for your participation. You may now disconnect.